

**DOCKET**



**SUPREME COURT**  
**OF THE UNITED STATES**

No. 11-1518

Title: Randy Curtis Bullock, Petitioner

v.

BankChampaign, N.A.

Docketed: June 18, 2012

Lower Ct: United States Court of Appeals for the Eleventh Circuit

Case Nos.: (11-11686-DD)

Decision Date: February 14, 2012

Rehearing March 16, 2012

Denied:

**Questions  
Presented**

~~~Date~~~ ~~~~~Proceedings and Orders~~~~~

Jun 14 2012 Petition for a writ of certiorari filed. (Response due July 18, 2012)

Aug 1 2012 DISTRIBUTED for Conference of September 24, 2012.

Aug 22 2012 Response Requested . (Due September 21, 2012)

Sep 20 2012 Brief of respondent BankChampaign, N.A. in opposition filed.

Sep 28 2012 Reply of petitioner Randy Curtis Bullock filed.

Oct 3 2012 DISTRIBUTED for Conference of October 26, 2012.

Oct 29 2012 Petition GRANTED.

Dec 11 2012 Letter of petitioner from counsel for the parties jointly proposing a lodging of the trust instrument that is the origin of the issues in this case filed. (Distributed)

Dec 13 2012 Joint appendix filed. (Statement of costs filed)

Dec 13 2012 Brief of petitioner Randy Curtis Bullock filed.

Dec 20 2012 Brief amicus curiae of G. Eric Brunstad, Jr. filed.

Jan 7 2013 SET FOR ARGUMENT ON Monday, March 18, 2013

Jan 11 2013 Brief of respondent BankChampaign, N.A. filed.

Jan 14 2013 Brief amici curiae of Professors Richard Aaron, et al. filed.

Jan 18 2013 Brief amicus curiae of United States filed.

Jan 18 2013 Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.

Jan 23 2013 CIRCULATED.

Jan 24 2013 Record received from U.S.C.A. for 11th Circuit. (1 box)

Feb 11 2013 Reply of petitioner Randy Curtis Bullock filed. (Distributed)

Feb 19 2013 Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.



Mar 18 2013 Argued. For petitioner: Thomas M. Byrne, Atlanta, Ga. For respondent: Bill D. Bensinger, Birmingham, Ala.; and Curtis E. Gannon, Assistant to the Solicitor General, Department of Justice, Washington, D. C. (for United States, as amicus curiae.)

Mar 18 2013 The Clerk has approved the parties' joint proposal to lodge copies of the trust instrument from the Illinois proceedings.

Mar 19 2013 Record from U.S.D.C. for Southern District of Alabama is electronic.

May 13 2013 Judgment VACATED and case REMANDED. Breyer, J., delivered the opinion for a unanimous Court.

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**PETITION  
FOR  
WRIT OF  
CERTIORARI**

IN THE  
**Supreme Court of the United States**

RANDY CURTIS BULLOCK,  
*Petitioner,*

v.

BANKCHAMPAIGN, N.A.,  
*Respondent.*

**On Petition for Writ of Certiorari to the  
United States Court of Appeals  
for the Eleventh Circuit**

**PETITION FOR A WRIT OF CERTIORARI**

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June 14, 2012

## **QUESTIONS PRESENTED**

What degree of misconduct by a trustee constitutes "defalcation" under § 523(a)(4) of the Bankruptcy Code that disqualifies the errant trustee's resulting debt from a bankruptcy discharge – and does it include actions that result in no loss of trust property?



## TABLE OF CONTENTS

|                                                                                                                                                                                          | Page |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| QUESTIONS PRESENTED.....                                                                                                                                                                 | i    |
| TABLE OF CONTENTS .....                                                                                                                                                                  | iii  |
| TABLE OF AUTHORITIES.....                                                                                                                                                                | v    |
| OPINIONS BELOW .....                                                                                                                                                                     | 1    |
| JURISDICTION .....                                                                                                                                                                       | 1    |
| STATUTORY PROVISIONS INVOLVED.....                                                                                                                                                       | 1    |
| STATEMENT OF THE CASE .....                                                                                                                                                              | 1    |
| REASONS FOR GRANTING THE WRIT.....                                                                                                                                                       | 5    |
| A. The Circuits Are Divided on the<br>Meaning of “Defalcation,” with the<br>Result of Inconsistent Application of<br>an Important Provision of Personal<br>Bankruptcy Law. ....          | 5    |
| B. The First and Second Circuit Approach<br>is Most Consistent with the Statutory<br>Text, Structure, and Purpose. ....                                                                  | 11   |
| CONCLUSION .....                                                                                                                                                                         | 14   |
| <b>APPENDIX</b>                                                                                                                                                                          |      |
| APPENDIX A: <i>Randy Curtis Bullock v.<br/>        BankChampaign, N.A. (In re Bullock)</i> , 670<br>F.3d 1160 (11th Cir. 2012) (Opinion of<br>Court).....                                | 1a   |
| APPENDIX B: <i>Randy Curtis Bullock v.<br/>        BankChampaign, N.A. (In re Bullock)</i> , No.<br>11-11686-DD (11th Cir. Mar. 16, 2012)<br>(Order Denying Petition for Rehearing)..... | 15a  |

## TABLE OF CONTENTS—Continued

|                                                                                                                                                                                                              | Page |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| APPENDIX C: <i>Randy Curtis Bullock v. BankChampaign, N.A. (In re Bullock)</i> , No. 10-cv-01905-IPJ (N.D. Ala. Mar. 22, 2011) (Memorandum Opinion) .....                                                    | 16a  |
| APPENDIX D: <i>BankChampaign, N.A. v. Randy Curtis Bullock (In re Randy Curtis Bullock)</i> , Ch. 7 Case No. 09-84300-JAC7, Adv. No. 10-80003-JAC (Bankr. N.D. Ala. May 27, 2010) (Memorandum Opinion) ..... | 29a  |
| APPENDIX E: <i>David S. Bullock v. Randall C. Bullock</i> , No. 99-CH-34 (Cir. Ct. for 5th Judicial Cir., Vermilion County, Ill. Dec. 22, 2002) (Order) .....                                                | 45a  |
| APPENDIX F: <i>David S. Bullock v. Randall C. Bullock</i> , No. 99-CH-34 (Cir. Ct. for 5th Judicial Cir., Vermilion County, Ill. June 11, 2002) (Memorandum and Order) .....                                 | 50a  |

## TABLE OF AUTHORITIES

| CASES                                                                                                  | Page    |
|--------------------------------------------------------------------------------------------------------|---------|
| <i>Blyler v. Hemmeter (In re Hemmeter)</i> , 242 F.3d 1186 (9th Cir. 2001).....                        | 10      |
| <i>Bullock v. BankChampaign, N.A. (In re Bullock)</i> , 670 F.3d 1160 (11th Cir. 2012)...              | 1, 7, 9 |
| <i>Commonwealth Land Title Co. v. Blaszak (In re Blaszak)</i> , 397 F.3d 386 (6th Cir. 2005).....      | 10      |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328 (1934).....                                        | 6       |
| <i>Denton ex rel. Denton v. Hyman (In re Hyman)</i> , 502 F.3d 61 (2d Cir. 2007).....                  | 5, 8    |
| <i>Ernst &amp; Ernst v. Hochfelder</i> , 425 U.S. 185 (1976).....                                      | 7, 8    |
| <i>FNFS, Ltd. v. Harwood (In re Harwood)</i> , 637 F.3d 615 (5th Cir. 2011).....                       | 9       |
| <i>Follett Higher Education Group v. Berman (In re Berman)</i> , 629 F.3d 761 (7th Cir. 2011).....     | 9       |
| <i>Freeman v. Quicken Loans, Inc.</i> , ___ U.S. ___, No. 10-1042, 2012 WL 1868063 (May 24, 2012)..... | 11      |
| <i>Gleason v. Thaw</i> , 236 U.S. 558 (1915).....                                                      | 6       |
| <i>Greebel v. FTP Software, Inc.</i> , 194 F.3d 185 (1st Cir. 1999).....                               | 7-8     |
| <i>Grogan v. Garner</i> , 498 U.S. 279 (1991) .....                                                    | 6       |
| <i>Kawaauhau v. Geiger</i> , 523 U.S. 57 (1998)...                                                     | 6, 12   |
| <i>Lewis v. Scott (In re Lewis)</i> , 97 F.3d 1182 (9th Cir. 1996).....                                | 10-11   |



## TABLE OF AUTHORITIES—Continued

|                                                                                                         | Page       |
|---------------------------------------------------------------------------------------------------------|------------|
| <i>Local Loan Co. v. Hunt</i> , 292 U.S. 234 (1934).....                                                | 6          |
| <i>McClellan v. Cantrell</i> , 217 F.3d 890 (7th Cir. 2000).....                                        | 11         |
| <i>Meyer v. Rigdon</i> , 36 F.3d 1375 (7th Cir. 1994).....                                              | 9          |
| <i>Moreno v. Ashworth (In re Moreno)</i> , 892 F.2d 417 (5th Cir. 1990).....                            | 9          |
| <i>Neal v. Clark</i> , 95 U.S. 704 (1877) .....                                                         | 11         |
| <i>Office of Thrift Supervision v. Felt (In re Felt)</i> , 255 F.3d 220 (5th Cir. 2001).....            | 9          |
| <i>Ormsby v. First American Title Co. (In re Ormsby)</i> , 591 F.3d 1199 (9th Cir. 2010)...             | 11-12      |
| <i>Pahlavi v. Ansari (In re Ansari)</i> , 113 F.3d 17 (4th Cir. 1997).....                              | 10         |
| <i>Palmacci v. Umpierrez</i> , 121 F.3d 781 (1st Cir. 1997).....                                        | 13         |
| <i>Patel v. Shamrock Floorcovering Services, Inc. (In re Patel)</i> , 565 F.3d 963 (6th Cir. 2009)..... | 9          |
| <i>R.E. America, Inc. v. Garver (In re Garver)</i> , 116 F.3d 176 (6th Cir. 1997).....                  | 10         |
| <i>Republic of Rwanda v. Uwimana (In re Uwimana)</i> , 274 F.3d 806 (4th Cir. 2001)...                  | 10         |
| <i>Rizek v. SEC</i> , 215 F.3d 157 (1st Cir. 2000)....                                                  | 8          |
| <i>Rutanen ex rel. Quevillon v. Baylis (In re Baylis)</i> , 313 F.3d 9 (1st Cir. 2002).....             | 7, 8-9, 11 |

## TABLE OF AUTHORITIES—Continued

|                                                                                                                 | Page  |
|-----------------------------------------------------------------------------------------------------------------|-------|
| <i>Schwager v. Fallas (In re Schwager)</i> , 121 F.3d 177 (5th Cir. 1997).....                                  | 9     |
| <i>Sherman v. Potapov (In re Sherman)</i> , 603 F.3d 11 (1st Cir. 2010) .....                                   | 11-12 |
| <i>Sherman v. SEC (In re Sherman)</i> , 658 F.3d 1009 (9th Cir. 2011).....                                      | 10    |
| <i>Tudor Oaks Limited Partnership v. Coch-<br/>rane (In re Cochrane)</i> , 124 F.3d 978 (8th<br>Cir. 1997)..... | 10    |
| <i>United States v. Williams</i> , 553 U.S. 285<br>(2008).....                                                  | 11    |
| <i>Williams v. United States Fidelity &amp;<br/>Guaranty Co.</i> , 236 U.S. 549 (1915).....                     | 6     |

## STATUTES, RULES, AND REGULATIONS

|                                                                       |               |
|-----------------------------------------------------------------------|---------------|
| 11 U.S.C. § 523(a)(2).....                                            | 6             |
| 11 U.S.C. § 523(a)(4).....                                            | <i>passim</i> |
| 11 U.S.C. § 523(a)(6).....                                            | 6, 12         |
| 11 U.S.C. § 523(a)(9).....                                            | 6             |
| 28 U.S.C. § 1254(1).....                                              | 1             |
| Bankruptcy Act of 1978, Pub. L. No. 95-<br>' 598, 92 Stat. 2549 ..... | 5-6           |

## **PETITION FOR A WRIT OF CERTIORARI**

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Randy Curtis Bullock respectfully petitions for a writ of certiorari to review a judgment of the United States Court of Appeals for the Eleventh Circuit.

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### **OPINIONS BELOW**

The opinion of the court of appeals is reported at 670 F.3d 1160 (11th Cir. 2012). Pet. App. 1a-14a. The respective memorandum opinions of the district and bankruptcy courts for the Northern District of Alabama are unreported. Pet. App. 16a-28a, 29a-44a.

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### **JURISDICTION**

The judgment of the court of appeals was entered on February 14, 2012. The court denied rehearing on March 16, 2012. Pet. App. 15a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

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### **STATUTORY PROVISIONS INVOLVED**

Section 523 of the United States Bankruptcy Code provides: "(a) A discharge under section 726, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . ."

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### **STATEMENT OF THE CASE**

1. This case began as a dispute among family members over administration of the father's life

insurance trust and ultimately resulted in the Chapter 7 bankruptcy of one of the children, petitioner Randy Curtis Bullock, who had been appointed by his father as trustee. Petitioner's father, Curt Bullock, created the trust, the Curt Bullock Trust No. 2, in 1978. The trust's sole asset was his father's life insurance policy, which featured a \$1 million death benefit and accumulated cash value. Petitioner and his siblings were named as beneficiaries. Until his father approached him about a loan from the trust, petitioner did not know that he was the trustee. In fact, neither he nor his four siblings were aware that the trust existed. Pet. App. 45a.

2. The dispute involved three loans taken against the cash value of the life insurance policy. All three loans were repaid in full, with six percent interest. Pet. App. 17a. The first loan, for \$117,545.96, was made in 1981 at the request of petitioner's father, the settlor of the trust. The loan went to petitioner's mother, Imogene Bullock, so that she could repay a debt that she owed to the family garage-construction business. Pet. App. 2a. The second loan, for \$80,257.04, was made in 1984 to petitioner and his mother. The loan proceeds were used to purchase certificates of deposit, which later were cashed and used, along with other funds, to purchase a garage fabrication mill in Springfield, Ohio, for approximately \$200,000.00. Pet. App. 2a. The third loan, for \$66,223.96, was made in 1990 to petitioner and his mother, and used in the purchase of an office building and other Springfield real estate. Pet. App. 2a. All of the loans, totaling \$264,026.96, were evidenced by notes to the trust, and were secured by first mortgages on property appraised for approximately \$447,000.00. Payments were made on the loans for 15 years.

Petitioner resigned as the trustee for the trust in 1998 at the request of some of the beneficiaries. Respondent, BankChampaign, N.A., was designated successor trustee. Within a few months after resigning, petitioner paid the remaining balance of the loans, with interest. The total of the payments made on the loans by petitioner and his mother was \$455,440.76.

3. In 1999, two of the five beneficiaries of the trust, petitioner's two brothers, filed an action in the Circuit Court of Vermilion County, Illinois, asserting claims that petitioner breached his fiduciary duty as trustee of the Curt Bullock Trust. Petitioner's brothers claimed that any profits earned by petitioner and his mother as a result of the loans should be turned over to the trust. The action also named other businesses in which petitioner had an interest as defendants and sought a constructive trust on all profits, proceeds, and assets obtained by petitioner and the other defendants. Pet. App. 47a.

4. The Illinois court found that petitioner did "not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a. The court made no other finding concerning petitioner's intent, motive, or state of mind. The court made no finding that petitioner committed a knowing or deliberate breach of fiduciary duty. But the court granted summary judgment in favor of petitioner's brothers because the fully-repaid loans were deemed self-dealing transactions and thus breaches of fiduciary duty under Illinois law. Pet. App. 57a. The court found that the trust did not earn any profit on the loans, which were repaid at the same interest rate charged by the insurance company. The court awarded damages to the trust of \$250,000, which the



court estimated to be the benefit obtained by petitioner from the breaches of duty, though characterizing the “actual monetary benefit” as “difficult to ascertain.” Pet. App. 46a. The court added an award of \$35,000 in attorneys’ fees to the trust, \$25,000 of which respondent was directed to pay to the two brothers who commenced the action. Pet. App. 47a-49a.

5. The Illinois court also impressed a constructive trust on the assets of petitioner and of two affiliated entities in the amount of the judgment against petitioner. Pet. App. 47a-48a. The constructive trust expressly included the Springfield mill property and petitioner’s beneficial interest in the Curt Bullock Trust. The effect of this order was to put petitioner’s assets, which he might have used toward payment of the judgment, in respondent’s control. In the years since entry of the Illinois judgment in 2002, respondent has rejected petitioner’s demands that the property subject to the constructive trust be liquidated to pay the judgment.

6. On October 21, 2009, petitioner filed for bankruptcy under Chapter 7 of the Bankruptcy Code seeking a discharge of his debts. Respondent, as successor trustee of the Curt Bullock Trust, filed an adversary proceeding on January 11, 2010 to obtain a ruling excepting petitioner’s obligations under the Illinois judgment from discharge under 11 U.S.C. § 523(a)(4). Petitioner answered and, though not a lawyer, defended himself *pro se* in the adversary proceeding. Respondent filed a motion for summary judgment contending that petitioner should be collaterally estopped from contesting issues that were decided by the Illinois court and that the Illinois court’s judgment established § 523(a)(4) “defalcation”

as a matter of law. On May 27, 2010, the bankruptcy court granted this motion. Pet. App. 29a-44a. Petitioner appealed to the district court, but it affirmed in an unpublished order. Pet. App. 16a-28a.

7. On further appeal, the United States Court of Appeals for the Eleventh Circuit acknowledged a split among the circuits as to the definition of “defalcation.” The court aligned itself with the Fifth, Sixth, and Seventh Circuits to hold that “defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless.” Pet. App. 10a-11a. The Eleventh Circuit determined that “self-dealing” was objectively reckless, and concluded that petitioner’s actions amounted to defalcation sufficient to except petitioner’s debt from discharge, even though the Illinois court had not found that petitioner committed a knowing breach of fiduciary duty. Pet. App. 11a.

## **REASONS FOR GRANTING THE WRIT**

### **A. The Circuits Are Divided on the Meaning of “Defalcation,” with the Result of Inconsistent Application of an Important Provision of Personal Bankruptcy Law.**

This case affords the Court a compelling opportunity to resolve a deep and longstanding conflict among the federal circuits concerning the meaning and application of the phrase “defalcation while acting in a fiduciary capacity” found in § 523(a)(4) of the Bankruptcy Code. One court has aptly characterized the current situation, detailed below, as “persistent confusion.” *Denton ex rel. Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 68 (2d Cir. 2007). The Court has not construed this provision since its inclusion in the Bankruptcy Act of 1978. Pub. L. No. 95-598, 92

Stat. 2549. The Court last interpreted a predecessor provision in *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934), but did not then address the quantum-of-culpability issue now presented.

The division among the circuits is best considered in the context of the statutory structure. The Court has posited that the exceptions of particular debts from bankruptcy discharge “should be confined to those plainly expressed.” *Kawaauhau v. Geiger*, 521 U.S. 57, 62 (1998) (quoting *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)). This rule of narrow construction reinforces the Bankruptcy Code’s “fresh start” policy long a foundation of bankruptcy law: “One of the primary purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.’” *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. United States Fidelity & Guaranty Co.*, 236 U.S. 549, 554-55 (1915)).

The discharge exception provision, § 523(a), is basically divisible into two groups of exceptions. See *Grogan v. Garner*, 498 U.S. 279, 287-88 (1991). The first group consists of types of debts that are *per se* non-dischargeable for various policy reasons: certain taxes, domestic support obligations, educational loans, restitution orders and the like. The second group of non-dischargeable debts are the product of wrongdoing, including debts resulting from willful and malicious injury, § 523(a)(6); fraud or certain false representations, § 523(a)(2); and death or injury caused by driving while intoxicated, § 523(a)(9). In this second group is § 523(a)(4)’s exception “for fraud



or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . .”

Courts seem to agree that not every breach of fiduciary duty amounts to a discharge-ineligible “defalcation.” But the consensus ends there. The federal circuits fall into three camps regarding the mental state required for a misappropriation or a failure to account to constitute “defalcation” under section 523(a)(4) of the Bankruptcy Code: (1) scienter or extreme recklessness, adhered to by the First and Second Circuits; (2) known breach of a fiduciary duty, such that the conduct can be characterized as “objectively reckless,” applied by the Eleventh Circuit in this case and by the Fifth, Sixth, and Seventh Circuits; and (3) mere negligence or innocent mistake resulting in misappropriation, applied by the Ninth, Fourth, and Eighth Circuits.<sup>1</sup>

#### 1. *Scienter or Extreme Recklessness*

The First and Second Circuits require “a mental state embracing intent to deceive, manipulate, or defraud” paralleling the scienter requirement in the well-developed law of securities fraud. *Rutanen ex rel. Quevillon v. Baylis (In re Baylis)*, 313 F.3d 9, 20 (1st Cir. 2002) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)). The standard can be met with a showing of “extreme recklessness” constituting “an extreme departure from the standards of ordinary care,” greater than the “mere conscious taking of risk associated with the usual torts standard of recklessness.” *Baylis*, 313 F.3d at 20 (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st

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<sup>1</sup> The D.C. Circuit has not considered the definition of defalcation. The Third and Tenth Circuits have not addressed defalcation in published opinions. *Bullock*, 670 F.3d at 1166.

Cir. 1999)). In *Hyman*, 502 F.3d at 68, the Second Circuit explicitly aligned itself with the First Circuit and adopted this scienter or extreme recklessness standard: “We believe that these concepts—well understood and commonly applied in the securities law context—strike the proper balance under section 523(a)(4). This standard ensures that the term ‘defalcation’ complements but does not dilute the other terms of the provision . . . all of which require a showing of actual wrongful intent.” *Id.*

*Baylis* involved a lawyer acting as co-trustee who was accused of various acts of defalcation. In its analysis, the First Circuit pointed out that the defalcation exception is located in the same sentence with exceptions for fraud, embezzlement, and larceny, all of which require specific intent. *Baylis*, 313 F.3d at 20 (excepting from discharge any debts “for fraud and defalcation while acting as a fiduciary, and embezzlement and larceny generally”). The court reasoned that an act that constitutes a defalcation “must be a serious one indeed, and some fault must be involved.” *Id.* at 19. “[A] creditor must be able to show that a debtor’s actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny.” *Id.* at 20. The court concluded that requiring “a mental state embracing intent to deceive, manipulate, or defraud,” borrowed from securities law, properly calibrated the meaning of defalcation with the level of culpability of fraud, embezzlement, and larceny also listed in subsection (a)(4), while avoiding redundancy with fiduciary “fraud” by also encompassing “extreme recklessness,” a “lesser form of intent.” *Id.* (quoting *Ernst & Ernst*, 425 U.S. at 193 n.12, and *Rizek v SEC*, 215 F.3d 157, 162 (1st Cir. 2000)). The court reversed the lower court’s exception from discharge of

all of Baylis's debts to the trust, but affirmed the exception from discharge to the extent he used trust funds to pay personal expenses.

## 2. *Knowing Breach or "Objectively Reckless"*

The Eleventh Circuit in this case joined the circuits that have adopted a recklessness standard that is less rigorous than the First and Second Circuits' standard. *Bullock v. BankChampaign, N.A. (In re Bullock)*, 670 F.3d 1160 (11th Cir. 2012). Pet. App. 1a-14a. These circuits require varying degrees of willfulness, knowledge, and objective recklessness, but all require something more than "mere negligence." See, e.g., *FNFS, Ltd. v. Harwood (In re Harwood)*, 637 F.3d 615 (5th Cir. 2011); *Patel v. Shamrock Floorcovering Servs., Inc. (In re Patel)*, 565 F.3d 963 (6th Cir. 2009); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994).

The Fifth Circuit requires "a willful neglect of duty" which is "essentially a recklessness standard." *Schwager v. Fallas (In re Schwager)*, 121 F.3d 177, 184-85 (5th Cir. 1997) (quoting *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417, 421 (5th Cir. 1990)). Willfulness is measured objectively based on "what a reasonable person in the debtor's position knew or reasonably should have known." *Harwood*, 637 F.3d at 624 (quoting *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001)). The Sixth and Seventh Circuits have recited a standard for defalcation that requires "something more than negligence or mistake, but less than fraud." *Follett Higher Educ. Grp. v. Berman (In re Berman)*, 629 F.3d 761, 765 n.3 (7th Cir. 2011) (citing *Meyer*, 36 F.3d at 1385); see *Patel*, 565 F.3d at 970 (labeling the standard as "objectively reckless" and rejecting "defalcation per se").

### 3. *Negligent or Innocent Mistake*

The most expansive reading of defalcation with holds discharge for even purely innocent mistake and has been adopted by the Fourth, Eighth, and Ninth Circuits. *Republic of Rwanda v. Uwimana* (*In re Uwimana*), 274 F.3d 806, 811 (4th Cir. 2001) (citing *Pahlavi v. Ansari* (*In re Ansari*), 113 F.3d 1720 (4th Cir. 1997)); *Tudor Oaks Ltd. P'ship v. Cochran* (*In re Cochran*), 124 F.3d 978, 984 (8th Cir. 1997); *Sherman v. SEC* (*In re Sherman*), 658 F.3d 1009, 1017 (9th Cir. 2011); *Blyler v. Hemmeter* (*In re Hemmeter*), 242 F.3d 1186, 1190-91 (9th Cir. 2001). In these circuits, "negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient." *Uwimana*, 274 F.3d at 811; see *Sherman*, 658 F.3d at 1017 ("[E]ven innocent act of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required.") (quoting *Hemmeter*, 242 F.3d at 1190-91).

### 4. *The Requirement of a Loss or "Failure to Account"*

The circuits also appear to conflict on the degree to which they require a creditor seeking to except an alleged defalcation debt from discharge to show that it has sustained a loss. The Eleventh Circuit here did not require that respondent prove a loss of principal; the court regarded the Illinois court's judgment of disgorgement of the purported benefit as alone sufficient. Other circuits appear to require that a loss of the entrusted property be demonstrated. *Commonwealth Land Title Co. v. Blaszak* (*In re Blaszak*), 397 F.3d 386, 390 (6th Cir. 2005) ("resulting loss" is required element); *R.E. Am., Inc. v. Garver* (*In re Garver*), 116 F.3d 176, 178 (6th Cir. 1997) (same); see



*Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1186 (9th Cir. 1996) (requiring “fail[ure] to account fully for money received”).

**B. The First and Second Circuit Approach is Most Consistent with the Statutory Text, Structure, and Purpose.**

Petitioner submits that the First Circuit’s view, expressed in *Baylis* and adopted by the Second Circuit as well, is the most faithful to the statutory text, structure, and purpose. That view comports with “the commonsense canon of *noscitur a sociis*—which counsels that a word is given more precise content by the neighboring words with which it is associated.” *Freeman v. Quicken Loans, Inc.*, \_\_\_ U.S. \_\_\_, No. 10-1042, 2012 WL 1868063, at \*6 (May 24, 2012) (quoting *United States v. Williams*, 553 U.S. 285, 294 (2008)). The Eleventh Circuit’s definition of defalcation is simply too lax to be ranked among the likes of “fraud . . . , embezzlement, or larceny” found in the same clause, all of which require findings of wrongful intent. Fraud in a fiduciary relationship as contemplated by § 523(a)(4) requires fraudulent intent. See *McClellan v. Cantrell*, 217 F.3d 890, 893-94 (7th Cir. 2000); see also *Neal v. Clark*, 95 U.S. 704, 709 (1877) (stating that fraud involves “moral turpitude or intentional wrong,” and that “[s]uch a construction . . . is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency.”). Both of the other crimes listed in § 523(a)(4), embezzlement and larceny, require criminal intent. See *Ormsby v. First Am. Title Co. (In re Ormsby)*, 591 F.3d 1199, 1205 (9th Cir. 2010); *Sherman v. Potapov (In re Sherman)*, 603 F.3d 11, 13 (1st Cir. 2010). Larceny is a taking of

personal property “with intent to convert it or deprive the owner” of it, *Ormsby*, 591 F.3d at 1205, while embezzlement constitutes the “fraudulent conversion of the property of another by one who is already in lawful possession of it,” *Sherman*, 603 F.3d at 1 (citations omitted). To construe “defalcation” more expansively, so as to allow an exception from discharge based on a lower threshold of wrongful intent would be anomalous.

In evaluating whether an exception from bankruptcy discharge that is predicated on a debtor’s serious misconduct should be imposed, the court should assess both the injury caused by the debtor’s action and the debtor’s mental state. Mere negligence or even recklessness should not be enough to warrant an exception from discharge under § 523(a)(4) any more than it is under § 523(a)(6). See *Kawaauhau*, 523 U.S. at 63-64 (holding that medical malpractice is not “willful and malicious” conduct). An honest trustee who, for instance, invests imprudently and produces a loss of *res* that results in his being held civilly liable should not be denied a bankruptcy discharge. Requiring a showing of a knowing wrongdoing or “extreme recklessness,” plus a failure to account for the entrusted property, would ensure a fresh start is denied only for the most serious of misconduct that results in a loss to another.

In petitioner’s case, there was no failure to account for the entrusted property, nor any loss of the trust principal. The investments chosen by petitioner, to a large degree for the benefit of his mother—the spouse of the trust settlor—were secured loans that were repaid on a regular schedule with interest, but not with any profit to the trust. The first loan, to his mother, was actually requested by his father. The

other two loans were made jointly to himself and his mother. The complaining parties were two of his siblings, children of the same parents. This was a squabble about family trust administration that escalated perversely and culminated in financial tragedy for petitioner. The judgment against petitioner was the state court's estimate of the benefit he received, not a reckoning for any loss.

As to his intent, there is no indication, much less any finding, that petitioner *knew* that the three loans made from his father's *inter vivos* life insurance trust were improper. The *only* judicial finding concerning petitioner's mental state was that his motive was apparently "not malicious." The burden to produce evidence of the requisite mental state was at all times on respondent, *see Palmacci v. Umpierrez*, 121 F.3d 781, 787 (1st Cir. 1997), but respondent sought summary judgment relying on the findings in the underlying state court action, a common tactic in exception-to-discharge litigation for a creditor holding a pre-bankruptcy judgment. But the state court's finding of no apparent ill intent, coupled with the fact of no resulting loss, falls far short of establishing the sort of grave misconduct that should deprive a financially-ruined individual from the statutory last refuge of discharge in bankruptcy. This case provides a vehicle for the Court to expound on the proper application of the statute to common and recurring fact patterns in the fiduciary context.

**CONCLUSION**

National bankruptcy laws should be uniformly applied in all states but, where exceptions to discharge are sought by creditors who assert defalcation debts, the outcomes now fluctuate from court to court. Petitioner respectfully submits that the Court should issue a writ of certiorari to remedy the prevailing confusion among the circuits, while undoing the injustice done to him.

Respectfully submitted,

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June 14, 2012



## **APPENDIX**

## APPENDIX TABLE OF CONTENTS

|                                                                                                                                                                                                              | Page |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| APPENDIX A: <i>Randy Curtis Bullock v. BankChampaign, N.A. (In re Bullock)</i> , 670 F.3d 1160 (11th Cir. 2012) (Opinion of Court) .....                                                                     | 1a   |
| APPENDIX B: <i>Randy Curtis Bullock v. BankChampaign, N.A. (In re Bullock)</i> , No. 11-11686-DD (11th Cir. Mar. 16, 2012) (Order Denying Petition for Rehearing) .....                                      | 15a  |
| APPENDIX C: <i>Randy Curtis Bullock v. BankChampaign, N.A. (In re Bullock)</i> , No. 10-cv-01905-IPJ (N.D. Ala. Mar. 22, 2011) (Memorandum Opinion) .....                                                    | 16a  |
| APPENDIX D: <i>BankChampaign, N.A. v. Randy Curtis Bullock (In re Randy Curtis Bullock)</i> , Ch. 7 Case No. 09-84300-JAC7, Adv. No. 10-80003-JAC (Bankr. N.D. Ala. May 27, 2010) (Memorandum Opinion) ..... | 29a  |
| APPENDIX E: <i>David S. Bullock v. Randall C. Bullock</i> , No. 99-CH-34 (Cir. Ct. for 5th Judicial Cir., Vermilion County, Ill. Dec. 22, 2002) (Order) .....                                                | 45a  |
| APPENDIX F: <i>David S. Bullock v. Randall C. Bullock</i> , No. 99-CH-34 (Cir. Ct. for 5th Judicial Cir., Vermilion County, Ill. June 11, 2002) (Memorandum and Order) .....                                 | 50a  |

1a

**APPENDIX A**

**UNITED STATES COURT OF APPEALS,  
ELEVENTH CIRCUIT**

---

No. 11-11686

---

IN RE RANDY CURTIS BULLOCK,  
*Debtor.*

---

RANDY CURTIS BULLOCK,  
*Appellant,*

v.

BANKCHAMPAIGN, N.A.,  
*Appellee.*

---

Feb. 14, 2012

---

Before BARKETT and PRYOR, Circuit Judges, and  
BUCKLEW,\* District Judge.

BUCKLEW, District Judge:

Appellant Randy Curtis Bullock, Debtor-Defendant in the underlying bankruptcy adversary proceeding, appeals the district court's decision affirming the bankruptcy court's determination that the Illinois judgment debt owed to Appellee BankChampaign, N.A. is not dischargeable, pursuant to 11 U.S.C. § 523(a)(4). After careful review and with the benefit of oral argument, we affirm.

---

\* Honorable Susan C. Bucklew, United States District Judge for the Middle District of Florida, sitting by designation.

### *1. Background*

In 1978, Appellant Bullock became the trustee of his father's trust. The trust's sole asset was a life insurance policy on his father's life, and Bullock and Bullock's four siblings were the beneficiaries. The terms of the trust provided that Bullock, as trustee, could borrow from the trust in only two situations: (1) to pay the life insurance premiums, and (2) to satisfy a beneficiary's request for withdrawal.

Despite the trust's limitations on borrowing, Bullock borrowed from the trust by making three loans that were secured by the cash value of the life insurance policy. First, in 1981, upon his father's request, Bullock borrowed \$117,545.96 for his mother so she could repay a debt that she owed to Bullock's father's business. Second, in 1984, Bullock borrowed \$80,257.04 for his mother and himself to purchase certificates of deposit, which were later cashed in and used toward the purchase of a garage fabrication mill in Ohio. Third, in 1990, Bullock borrowed \$66,223.96 for his mother and himself to purchase real estate. These loans were all fully repaid.

Thereafter, Bullock's two brothers learned of the existence of the trust, and they filed suit against Bullock in Illinois state court. In the lawsuit, Bullock's brothers claimed that Bullock had breached his fiduciary duty as trustee by engaging in self-dealing via the three loans. The brothers moved for summary judgment on that claim, and in 2002, the Illinois court granted their motion. Specifically, the Illinois court stated that it could not "be disputed the loans made by [Bullock] while acting as trustee are considered self-dealing transactions. All of the loans were made to entities [Bullock] had a financial interest in or to a relative." [R:Tab K].

In its order awarding damages for the self-dealing, the Illinois court stated that Bullock did “not appear to have had a malicious motive in borrowing funds from the trust.” [R:Tab M, Ex. 7]. However, the Illinois court concluded that “neither the facts and circumstances surrounding the loans nor the motives of [Bullock] can excuse him from liability.” [R:Tab M, Ex. 7]. As a result, the Illinois court determined that damages should be awarded based on the benefit that Bullock received due to the self-dealing. The Illinois court stated that such would be hard to quantify, but based on its equitable powers, it determined that \$250,000 represented the amount of the benefit that Bullock had received from the self-dealing. In addition, the Illinois court ordered that Bullock pay \$35,000 in attorneys’ fees. The Illinois court also put the property obtained with the self-dealt funds (a mill located in Ohio) under a constructive trust to secure it as collateral for the \$285,000 judgment amount. The Illinois court placed another constructive trust on Bullock’s beneficial interest in his father’s trust as an additional source of collateral for the judgment.

The constructive trusts were awarded to Appellee BankChampaign (“Bank”), which had replaced Bullock as the trustee of his father’s trust. Bullock contends that the Bank, as trustee, has blocked his attempts to sell or lease the mill property located in Ohio, which has prevented him from satisfying the Illinois judgment.<sup>1</sup>

Thereafter, in 2009, Bullock filed for bankruptcy under Chapter 7 in hopes that he could discharge the

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<sup>1</sup> Because the Illinois court awarded the Bank a constructive trust over the Ohio mill, Bullock is unable to sell or lease the mill without the approval and cooperation of the Bank.

Illinois judgment debt. The Bank initiated an adversary proceeding to determine the dischargeability of the judgment debt pursuant to 11 U.S.C. § 523(a)(4). Section 523(a)(4) provides that debts arising from “fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny” are not dischargeable in bankruptcy. The Bank moved for summary judgment, arguing that the Illinois judgment debt was not dischargeable, and the bankruptcy court granted the Bank’s motion.

Specifically, the bankruptcy court concluded that Bullock was collaterally estopped from attacking the Illinois judgment. The Illinois court had determined that Bullock had breached his fiduciary duty by self-dealing via the three loans. The bankruptcy court accepted the Illinois court’s determination that Bullock had breached his fiduciary duty by engaging in self-dealing and concluded that such conduct amounted to fraud and defalcation. As a result, the bankruptcy court found that the Illinois judgment was a debt arising from fraud or defalcation while Bullock was acting in a fiduciary capacity, and as such, the judgment debt was not dischargeable, pursuant to § 523(a)(4).

Bullock appealed the bankruptcy court’s judgment to the district court. The district court affirmed the bankruptcy court’s decision, but it sympathized with Bullock’s predicament—he had a judgment debt that he could satisfy only by selling the underlying collateral, but the Bank persisted in preventing the sale. The district court stated that it questioned the propriety of the Bank’s actions and noted that holding collateral hostage in perpetuity is impermissible. However, the district court recognized that the propriety of the Bank’s actions was not a basis for



finding that the judgment debt should be discharged. As a result, the district court concluded that while it was “convinced [the Bank] is abusing its position of trust by failing to liquidate the [property], this issue is not properly before this court, but rather should [be] brought by Bullock in an action in Illinois to consider the malfeasance of the trustee.” [R:Tab G].

Thereafter, Bullock filed the instant appeal. In this appeal, Bullock argues that the bankruptcy court erred in two ways: (1) by concluding that the Illinois judgment was non-dischargeable, pursuant to § 523(a)(4); and (2) by failing to consider his affirmative defense that the Bank has acted wrongfully by impeding his attempts to sell or lease the collateralized property.

## *II. Standard of Review*

“Because the district court in reviewing the decision of a bankruptcy court functions as an appellate court, we are the second appellate court to consider this case. Thus, this Court’s review with regard to determinations of law, whether made by the bankruptcy court or by the district court, is *de novo*. The district court makes no independent factual findings; accordingly, we review solely the bankruptcy court’s factual determinations under the ‘clearly erroneous’ standard.” *In re Colortex Indus., Inc.*, 19 F.3d 1371, 1374 (11th Cir. 1994) (citations omitted).

## *III. Section 523(a)(4)*

In determining whether the Illinois judgment debt should be discharged, this Court is mindful of the purpose of the Bankruptcy Code:

A central purpose of the Bankruptcy Code is to provide an opportunity for certain insolvent

debtors to discharge their debts and enjoy a fresh start. However, Congress has decided to exclude from the general policy of discharge certain categories of debts. One of these categories includes debts incurred by fraud or defalcation while acting in a fiduciary capacity. Such a debt is non-dischargeable [under 11 U.S.C. § 523(a)(4)]. Congress evidently concluded that the creditors' interest in recovering full payment of such debts ... outweighed the debtors' interest in a complete fresh start.

*Eavenson v. Ramey*, 243 B.R. 160, 164 (N.D. Ga. 1999) (alterations, citations, and internal quotation marks omitted). Furthermore, this Court must keep in mind that exceptions to discharge, such as § 523(a)(4), must be construed narrowly, and the burden is on the creditor to show that the exception to discharge applies. See *In re Mitchell*, 633 F.3d 1319, 1327 (11th Cir. 2011) (citations omitted).

In the underlying adversary proceeding, the Bank asked the bankruptcy court to find the Illinois judgment debt to be non-dischargeable under § 523(a)(4). The bankruptcy court concluded that the debt was not dischargeable because the Bank had established that the debt arose from fraud or defalcation while Bullock was acting in a fiduciary capacity. The parties do not dispute that the judgment debt arose from conduct that occurred while Bullock was acting in a fiduciary capacity (i.e., while he was the trustee of his father's trust). Furthermore, at oral argument, Bullock appeared to concede that he was collaterally estopped from attacking the Illinois judgment to the extent that the Illinois court concluded that he breached his fiduciary duty as the trustee of his father's trust by engaging in self-dealing via the



three loans. Thus, the issue before this Court is whether the bankruptcy court correctly characterized Bullock's conduct as fraud and/or defalcation under § 523(a)(4). Upon consideration, we find that Bullock's conduct constituted defalcation under § 523(a)(4).<sup>2</sup>

This Court has stated that a "[d]efalcation" refers to a failure to produce funds entrusted to a fiduciary" and that "the precise meaning of 'defalcation' for purposes of § 523(a)(4) has never been entirely clear." *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993) (citations omitted). However, this Court has referred to the Second Circuit's decision in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937), as containing "perhaps the best" analysis of the meaning of "defalcation" under § 523(a)(4).<sup>3</sup> *Quaif*, 4 F.3d at 955; see also *In re Fernandez-Rocha*, 451 F.3d 813, 817 (11th Cir. 2006).

In *Central Hanover*, an issue before the court was whether Herbst, who had been appointed as a receiver for real property in a foreclosure action, had committed a defalcation when he withdrew money that the court had awarded him as payment for his services as receiver before the time to appeal the order awarding him the money had expired. See *Central Hanover*, 93 F.2d at 511. The *Central Hanover* court analyzed the bankruptcy statute that provided that debts arising from fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in a fiduciary capacity were not

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<sup>2</sup> Because we find that Bullock's conduct constituted defalcation under § 523(a)(4), we need not reach the issue of whether his conduct also constituted fraud under § 523(a)(4).

<sup>3</sup> The court in *Central Hanover* analyzed the meaning of defalcation under the predecessor statute to § 523(a)(4).

dischargeable. *See id.* In analyzing the meaning of defalcation, the *Central Hanover* court stated the following:

Whatever was the original meaning of defalcation, it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'

...

In the case at bar [Herbst] had not been entirely innocent . . . . A judge had awarded him the money, and *prima facie* he was entitled to it; but he knew, or if he did not know, he was charged with notice (having held himself out as competent to be an officer of the court), that the order would not protect him if it were reversed; and that it might be reversed until the time to appeal had expired. He made no effort to learn from the plaintiff whether it meant to appeal, and he did not wait until it could no longer do so; he took his chances. We do not hold that no possible deficiency in a fiduciary's accounts is dischargeable; . . . [we have said] that the misappropriation must be due to a known breach of the duty, and not to mere negligence or mistake. Although [misappropriation] probably carries a larger implication of misconduct than defalcation, defalcation may demand some portion of misconduct; we will assume *arguendo* that it does.

All we decide is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a defalcation though it may not be a

fraud, or an embezzlement, or perhaps not even a misappropriation.

*Id.* at 511, 512 (citation and internal quotation marks).

In *Quaif*, this Court interpreted *Central Hanover* as standing for the proposition that a defalcation under § 523(a)(4) does not have to rise to the level of fraud, embezzlement, or misappropriation.<sup>4</sup> See *Quaif*, 4 F.3d at 955. Additionally, this Court in *Quaif* noted that some courts interpret defalcation “more broadly, stating that even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4).” *Id.* (citations omitted).

This Court recognizes that there is a split among the circuits regarding the meaning of defalcation under § 523(a)(4). The Fourth, Eighth, and Ninth Circuits have concluded that even an innocent act by a fiduciary can be a defalcation. See *In re Uwimana*, 274 F.3d 806, 811 (4th Cir. 2001) (stating that “even an innocent mistake which results in misappropriation or failure to account” can be a defalcation); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997) (concluding that defalcation does not require intentional wrongdoing; stating that it includes a fiduciary’s innocent failure to fully account for money received); *In re Sherman*, 658 F.3d 1009, 1017 (9th Cir. 2011) (noting that intent to defraud is not required; stating

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<sup>4</sup> In *Quaif*, an issue before the Court was whether an agent who failed to remit insurance premiums, and instead commingled the money with his company’s funds and used the funds to pay his company’s operating expenses, committed a defalcation. See *Quaif*, 4 F.3d at 952. The *Quaif* Court held that the agent’s conduct was a defalcation within the meaning of § 523(a)(4). See *id.* at 955.

that defalcation includes a fiduciary's innocent failure to fully account for money received). The Fifth, Sixth, and Seventh Circuits require a showing of recklessness by the fiduciary. *See In re Harwood*, 637 F.3d 615, 624 (5th Cir. 2011) (stating that defalcation is a willful neglect of a duty, which does not require actual intent; it is essentially a recklessness standard); *In re Patel*, 565 F.3d 963, 970 (6th Cir. 2009) (stating that a defalcation requires a showing of more than negligence; instead, the fiduciary "must have been objectively reckless in failing to properly account for or allocate funds"); *In re Berman*, 629 F.3d 761, 766 n. 3 (7th Cir. 2011) (stating that "defalcation requires something more than negligence or mistake, but less than fraud"). The First and Second Circuits require a showing of extreme recklessness.<sup>5</sup> *See In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002) (stating that "defalcation requires something close to a showing of extreme recklessness"); *In re Hyman*, 502 F.3d 61, 68 (2d Cir. 2007) (stating that defalcation "requires a showing of conscious misbehavior or extreme recklessness"). The Third Circuit has not addressed the issue, and the Tenth Circuit has made the brief statement in an unpublished opinion that defalcation requires some portion of misconduct. *See In re Millikan*, 188 Fed.Appx. 699, 702 (10th Cir. 2006).

Given our Circuit's explicit alignment with the *Central Hanover* case, this Court finds that defalcation under § 523(a)(4) requires more than mere negligence. Instead, this Court concludes that defalcation requires a known breach of a fiduciary duty,

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<sup>5</sup> In 2007, the Second Circuit re-evaluated the position that it took in the *Central Hanover* case and determined that it would align itself with the First Circuit when defining defalcation under § 523(a)(4).



such that the conduct can be characterized as objectively reckless. As such, this Circuit aligns itself with the Fifth, Sixth, and Seventh Circuits, which hold that defalcation under § 523(a)(4) requires a showing of recklessness by the fiduciary.

Applying the recklessness standard for defalcation to the facts of the instant case, this Court concludes that the bankruptcy court was correct in determining that Bullock committed a defalcation by making the three loans while he was the trustee of his father's trust. Because Bullock was the trustee of the trust, he certainly should have known that he was engaging in self-dealing, given that he knowingly benefitted from the loans. Thus, his conduct can be characterized as objectively reckless, and as such, it rises to the level of a defalcation under § 523(a)(4). Accordingly, the bankruptcy court's order must be affirmed on the issue of whether the Illinois judgment debt was non-dischargeable under § 523(a)(4) as a debt arising from a defalcation while Bullock was acting in a fiduciary capacity.

#### *IV. Affirmative Defense*

Bullock also argues that the bankruptcy court erred in failing to consider his affirmative defense that the Bank has acted wrongfully by impeding his attempts to sell or lease the collateralized property. Bullock cites *Heller v. Lee*, 130 Ill.App.3d 701, 85 Ill.Dec. 896, 474 N.E.2d 856 (1985), in support of his argument that the Bank's conduct has been wrongful.

In *Heller*, the plaintiffs obtained a judgment of more than \$44,000 against the defendants. *See id.* at 857. The defendants had put up a bond consisting of a \$15,000 certificate of deposit and a deed to real property appraised at \$50,000. *See id.* After the judg-

ment was affirmed on appeal, the plaintiffs moved to release the bond, and the plaintiffs applied the \$15,000 certificate of deposit to the outstanding judgment. *See id.* Thereafter, the defendants moved under an Illinois statute for a release from the judgment due to the plaintiffs acquiring the deed to the real property via the release of the bond. *See id.* While the court found that the defendants did not satisfy the requirement for release from judgment under the Illinois statute, the court found that the defendants were entitled to equitable relief and stated the following:

The plaintiffs contend that they took the property as security for eventual cash payment of the judgment. We agree. But, as matters now stand, the plaintiffs can sit on the property indefinitely and institute supplemental proceedings to recover the rest of the judgment. Thus the plaintiffs have the use and enjoyment of a valuable piece of property while the defendants, who put the property up as bond expecting it to satisfy the judgment, are not only deprived of the property, but may also be compelled to dig even deeper in order to pay the judgment. Such a result is inequitable. The plaintiffs have received a windfall at the defendants' expense. If, as the plaintiffs contend, the transfer of the real estate was intended to secure the judgment, then by taking the deed, the plaintiffs acquired only a lien. Rather than proceed against the defendants to recover the judgment, the equitable solution is for the plaintiffs to foreclose on their lien by selling the property.

We are guided in this result by the maxim that equity regards as done that which ought to be

done. The parties intended the property to secure the judgment. Therefore, the property should be used to satisfy the judgment.

. . . The cause is remanded and the trial court is directed to sell the property, apply the proceeds to the judgment, and remit the excess, if any, to the defendants.

*Id.* at 858.

Thus, based on *Heller*, Bullock argues that the Bank's actions regarding the collateral in this case have been wrongful and inequitable. Bullock takes this argument a step further and contends that because the bankruptcy court is a court of equity, and because the Bank has come to the bankruptcy court with unclean hands due to its wrongful conduct, the bankruptcy court should deny the Bank its requested relief of non-dischargeability. See *Matter of Garfinkle*, 672 F.2d 1340, 1347 n.7 (11th Cir. 1982) ("The doctrine [of unclean hands] is applicable in a court of equity to deny a plaintiff the relief he seeks even though his claim might otherwise be meritorious. The principles of equity govern the exercise of a bankruptcy court's jurisdiction.").

Bullock, however, has not cited any cases in which a court found a debt met the requirements of non-dischargeability under § 523(a) but ultimately concluded that the debt was dischargeable due to the creditor's unclean hands. Therefore, this Court concludes that the district court correctly determined that the propriety of the Bank's actions is not a basis for finding that the Illinois judgment debt should be discharged. Instead, this Court agrees with the district court's statement that while it was "convinced [the Bank] is abusing its position of trust by

failing to liquidate the [property], this issue is not properly before this court, but rather should [be] brought by Bullock in an action in Illinois to consider the malfeasance of the trustee." [R:Tab G].

This Court notes that if it accepted Bullock's argument and concluded that the judgment debt was dischargeable, Bullock would ultimately pay nothing more on the debt, as the debt would be discharged. However, if Bullock goes back to the Illinois court and raises the issue of the Bank's inequitable conduct, the Illinois court may order the Bank to liquidate the collateral, and as a result, it is possible that the Bank could be paid from the sale and that the judgment debt could be reduced or eliminated.<sup>6</sup> Thus, having Bullock go to the Illinois court to raise the issue of the Bank's inequitable conduct would likely lead to the most equitable resolution of the situation.

#### *V. Conclusion*

Accordingly, the decision of the bankruptcy court is **AFFIRMED**.

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<sup>6</sup> The market value of the collateral is not in the record before this Court.



15a

**APPENDIX B**

**IN THE UNITED STATES COURT OF APPEALS  
FOR THE ELEVENTH CIRCUIT**

[Filed March 16, 2012]

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No. 11-11686-DD

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In Re: RANDY CURTIS BULLOCK,  
*Debtor.*

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RANDY CURTIS BULLOCK,  
*Plaintiff-Appellant,*  
v.

BANKCHAMPAIGN, N.A.,  
*Defendant-Appellee.*

---

Appeal from the United States District Court  
for the Northern District of Alabama

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BEFORE: BARKETT and PRYOR, Circuit Judges,  
and BUCKLEW,\* District Judge.

PER CURIAM:

The petition(s) for rehearing filed by Appellant is  
**DENIED.**

ENTERED FOR THE COURT:

/s/ Rosemary Barkett  
UNITED STATES CIRCUIT JUDGE

ORD-41

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\* Honorable Susan C. Bucklew, United States District Judge  
for the Middle District of Florida, sitting by designation.

**APPENDIX C**

**IN THE UNITED STATES DISTRICT COURT  
FOR THE NORTHERN DISTRICT OF ALABAMA  
NORTHEASTERN DIVISION**

[Filed March 22, 2011]

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**BANKRUPTCY COURT CASE  
NO.: 09-84300**

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**IN RE: RANDALL CURTIS BULLOCK,**  
*Debtor.*

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**CASE NO.: CV-10-J-1905-NE  
No.: AP-10-80003**

---

**RANDALL CURTIS BULLOCK,**  
*Appellant,*

**v.**

**BANK CHAMPAIGN, NA,**  
*Appellee.*

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**MEMORANDUM OPINION**

This matter is before the court as an appeal from the Bankruptcy Court, pursuant to 28 U.S.C. § 158. The parties have filed appellate briefs, which the court has reviewed. The court finds, in accordance in Fed.R.Bankr.P. 8012, that the facts and legal arguments are adequately presented in the briefs and record and the decisional process will not be significantly aided by oral argument.

## FACTUAL BACKGROUND

The facts of this appeal are not in dispute. It arises from an adversarial proceeding in which summary judgment was granted in favor of appellee Bank Champaign and against the debtor/appellant, Randall Bullock ("Bullock"). Bullock at one time was trustee of the Curtis Bullock Trust No. 2, created by Bullock's father as an irrevocable living trust. The only asset was the proceeds of a life insurance policy on the life of the father. Bullock was named trustee and he and his four siblings were the beneficiaries.

Pursuant to trust documents, the trustee could borrow against the policy to provide funds to pay the premiums, or to satisfy any request of a beneficiary for withdrawal of funds. Bullock borrowed against the cash value of the policy three times. The first loan was at the request of the father to benefit his wife (Bullock's mother), in the amount of \$117,545.96, to repay a debt she owed to the father's business. The second loan was to Bullock and his mother, for \$80,257.04, to purchase Certificates of Deposit. Later, these funds were used toward the purchase of a garage fabrication mill in Ohio. A third loan for \$66,223.96, again to Bullock and his mother, was used with other funds to purchase real estate. Bullock alleges that the loans were repaid in full with six percent (6%) interest, but an Illinois trial court ruled the trust made no profit from the loans.

The Illinois case arose in 2001 when Bullock's two brothers filed suit asserting Bullock breached his fiduciary duty and that any profits earned by Bullock and his mother should be relinquished to the trust. The Illinois court held that Bullock was liable for self-dealing and owed the trust \$250,000.00 for benefits he received and \$35,000.00 in attorney fees. It

also held that the loans were not for either of the two permissible purposes in the trust documents. It found the loans were the result of self-dealing, because each time the money went to entities in which Bullock had an interest. That court declared a constructive trust on Bullock's assets, plus several businesses in which Bullock had an interest, and on his interest in the trust. The Illinois court further named Bank Champaign, NA ("Appellee") as trustee.

According to Bullock, the Illinois court ordered that the defendant in that case, namely Bullock, having an interest in the Springfield mill had to execute a mortgage on the property in favor of the trustee. Appellee has held the assets of the constructive trust since that time without making an effort to liquidate the assets to satisfy the court judgment, and has refused to let Bullock sell or lease the property to satisfy the judgment.

Bullock then filed a Chapter 7 bankruptcy action, seeking to discharge solely this debt. Appellee filed an adversarial proceeding ("AP") against Bullock, alleging that Bullock, in his previous role as trustee of the Trust, committed acts of defalcation while acting in a fiduciary capacity. Such allegations had been raised in the state court action in Illinois, and were the basis of the judgment in favor of other heirs of the trust and against Bullock. Appellee argued in the adversarial proceeding that the debt created by the Illinois judgment was non-dischargeable, and the Bankruptcy court agreed. This issue of the dischargeability of the debt created by the Illinois judgment is the sole issue before this court on appeal.

Bullock's two sisters both asked the Bankruptcy court to release Bullock from the debt because the litigation has been going on for fourteen years and

needed to stop. Bullock had produced a buyer for one of the properties, but Appellee refused to allow the sale. Because it is the trustee, and the trust holds a constructive trust on the assets, nothing may be sold without Appellee's approval. Meanwhile, the properties are essentially abandoned and uninsurable.

In the adversarial proceeding before the bankruptcy court, Appellee argued that Bullock was collaterally estopped from raising any issues raised in the Illinois action. The bankruptcy court assumably agreed, ruling on motion for summary judgment that the Illinois court found fraud and defalcation and that Bullock was collaterally estopped from relitigating such issues.

### Standard of Review

This court functions as an appellate court for the decisions of the United States Bankruptcy Courts. *In re Sublett*, 895 F.2d 1381, 1383 (11th Cir. 1990). This court reviews the Bankruptcy court's findings of fact under the clearly erroneous standard of review and conclusions of law under the de novo standard of review. *Whiting-Turner Contracting Co. v. Electric Machinery Enterprises, Inc.*, 2006 WL 1679357, \*1 (M.D.Fla.2006). De novo review requires the court to make a judgment "independent of the bankruptcy court's, without deference to that court's analysis and conclusions." *In re Sternberg*, 229 B.R. 238, 244 (S.D.Fla.1998); citing *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1210 (7th Cir.1984). The proper construction of the Bankruptcy Code by the bankruptcy court or by the district court is a matter of law; accordingly, such interpretations are subject to de novo review. *In re Colortex Industries, Inc.*, 19 F.3d 1371, 1374 (11th Cir.1994); *In re Taylor*, 3 F.3d 1512, 1514 (11th Cir. 1993).



Under Fed.R.Civ.P. 56(c), made applicable to adversary proceedings and contested matters in bankruptcy cases by Fed.R.Bankr.P. 7056 and 9014, summary judgment is proper "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *In re Optical Technologies, Inc.*, 246 F.3d 1332, 1334 (11th Cir.2001); citing Fed.R. Civ.P 56(c); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 2552, 91 L.Ed.2d 265 (1986). This court's review of a bankruptcy court's grant of summary judgment is de novo. See *In re Optical Technologies, Inc.*, 246 F.3d at 1334; *In re Walker*, 48 F.3d 1161, 1163 (11th Cir. 1995). De novo review requires the court to make a judgment independent of the bankruptcy court's, without deference to that court's analysis and conclusions. *In re Piper Aircraft Corp.*, 244 F.3d 1289, 1295 (11th Cir.2001), citing *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1210 (7th Cir.1984).

### Legal Analysis

As stated above, the sole issue before this court is whether the Bankruptcy court erred in holding the debt created by the Illinois court judgment was non-dischargeable. See appellant's brief at 2, appellee's brief at 1. Specifically, Bullock asserts the Bankruptcy Court erred in holding that Bullock committed an act of fraud and/or defalcation pursuant to 11 U.S.C. § 523(a)(4), or that this issue was previously litigated and adjudicated in the Illinois action.<sup>1</sup>

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<sup>1</sup> The Bankruptcy court can apply collateral estoppel on the issue of liability or the issue of liability and damages to the extent those issues were litigated in a prior action, but the Bankruptcy court must still determine on the basis of those



He further asserts that the Bankruptcy court failed to consider his affirmative defenses. The appellee responds that the Bankruptcy court correctly determined it was collaterally estopped from reconsidering the Illinois state court judgment.

Pursuant to section 523(a)(4) of the Bankruptcy Code, any debt arising from “fraud or defalcation while acting in a fiduciary capacity” is excepted from discharge. 11 U.S.C. § 523(a)(4). The parties do not dispute that Bullock was, at all times relevant, acting in a fiduciary capacity. Thus, the court considers whether the debt created by the Illinois court judgment arose from fraud or defalcation. The exception from dischargeability created by § 523(a)(4) is construed narrowly. See *In re Fernandez-Rocha*, 451 F.3d 813, 816 (11th Cir. 2006). Although Bullock defines “defalcation” to require a failure to produce funds, the Eleventh Circuit has not recognized the same to be the only definition of “defalcation.” Examining this very issue, the Court held:

Even if a fiduciary relationship exists prior to the act that created the debt, the next question under § 523(a)(4) is whether there was a “defalcation” while acting in a fiduciary capacity. In *Quaif*, this Court further explained that “[d]efalcation” refers to a failure to produce funds entrusted to a fiduciary,” but that “the precise meaning of ‘defalcation’ for purposes of § 523(a)(4) has never been entirely clear.” *Id.* at 955. *Quaif* observed that the best analysis of “defalcation” is that of Judge Learned Hand in *Central Hanover*

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proven facts whether those acts come within the dischargeability sections of the Bankruptcy Code. *In re Lowery*, 440 B.R. 914, 923 (Bkrtcy.N.D.Ga.2010).

*Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937), in which “Judge Hand concluded that while a purely innocent mistake by the fiduciary may be dischargeable, a ‘defalcation’ for purposes of this statute does not have to rise to the level of ‘fraud,’ ‘embezzlement,’ or even ‘misappropriation.’” *Quaif*, 4 F.3d at 955 (citing *Central Hanover*, 93 F.2d at 512). **Indeed, “[s]ome cases have read the term even more broadly, stating that even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4).”** *Id.* (emphasis added).

*In re Fernandez-Rocha*, 451 F.3d at 817 (quoting *Quaif v. Johnson*, 4 F.3d 950 (11th Cir.1993)). Furthermore, the non-dischargeability language of § 523(a)(4) does not require defalcation, the statute addresses fraud as well. See e.g., *Hosey v. Hosey* (*in re Hosey*), 355 B.R. 311, 321 (Bankr.N.D.Ala.2006).

Bullock’s arguments otherwise arise from a linguistic misinterpretation of the term “failure to produce funds entrusted to a fiduciary.” Even though Bullock repaid the funds, this is not the same as never having taken them out of the trust in the first place. Rather, defalcation includes the fiduciary’s failure to account for funds due to any breach of duty whether it was intentional, willful, reckless, or negligent. Proof of fraud is not needed. See *In re Moreno*, 892 F.2d 417, 421 (5th Cir.1990); *In re Wang*, 247 B.R. 211 (Bankr.E.D.Tex.2000); *In re Storie*, 216 B.R. 283 (10th Cir. 1997).

More specifically, “[a] defalcation is a willful neglect of duty, even if not accompanied by fraud or embezzlement.” *In re Moreno*, 892 F.2d at 421, citing L. King, 3 Collier on Bankruptcy ¶ 523.14, at 523-93 to 523-95 (15 ed. 1988), quoting *Central Hanover*

*Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2nd Cir.1937) (L. Hand, J.). Bullock's fiduciary duty "encompassed, at least, a responsibility not to lend [the trust]'s money to himself or corporations controlled by him on less than an arms-length basis." *In re Moreno*, 892 F.2d at 421 (citing *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *International Bankers Life Insurance. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963).).

In consideration of the foregoing, the court finds nothing erroneous in the Bankruptcy court's determination that the Illinois state court judgment was non-dischargeable pursuant to 11 U.S.C. § 523 (a)(4). However, even if this court disagreed with the determination of the Bankruptcy court and the Illinois court concerning the legitimacy of the loans to Bullock, this court finds the Bankruptcy court further was correct in its finding that it was collaterally estopped from reopening this issue.

A court's application of estoppel determinations made originally by a bankruptcy court presents questions of law reviewed de novo. *In re Piper Aircraft Corp.*, 244 F.3d 1289, 1295 (11th Cir.2001), citing *Richardson v. Miller*, 101 F.3d 665, 667-68 (11th Cir. 1996); *In re Justice Oaks II, Ltd.*, 898 F.2d 1544, 1550 (11th Cir. 1990). Collateral estoppel prevents the relitigation of issues already litigated and determined by a valid and final judgment in another court. It is well-established that the doctrine of collateral estoppel applies in a discharge exception proceeding in bankruptcy court. *In re Bilzerian*, 100 F.3d 886, 892(11thCir.1996), citing *Grogan v. Garner*, 498 U.S. 279, 284 n. 11, 111 S.Ct. 654, 658 n. 11, 112 L.Ed.2d 755 (1991); *Hoskins v. Yanks (In re Yanks)*, 931 F.2d

42, 43 n. 1 (11th Cir. 1991). For collateral estoppel to apply, the following elements must be present:

- (1) The issue in the prior action and the issue in the bankruptcy court are identical;
- (2) The bankruptcy issue was actually litigated in the prior action;
- (3) The determination of the issue in the prior action was a critical and necessary part of the judgment in that litigation; and
- (4) The burden of persuasion in the discharge proceeding must not be significantly heavier than the burden of persuasion in the initial action.

*Bilzerian*, 100 F.3d at 892 citing *Bush v. Balfour Beatty Bahamas, Ltd. (In re Bush)*, 62 F.3d 1319, 1322 (11th Cir.1995) (citation omitted).

As set forth above, the court has already found that the issue of the propriety of Bullock's actions in handling the trust monies was before both the Illinois court and the Bankruptcy court. The issue in both cases, namely the question of breach of fiduciary duties, was actually litigated in the Illinois action. As the only issue before the Illinois court, it was a critical and necessary part of the judgment in that action. In the Bankruptcy court, Bullock challenged the finding that his actions were within the definition of fraud or defalcation. That court rendered its decision on the non-dischargeability of the debt based on the Illinois court's finding that Bullock breached his fiduciary duties. Therefore, the fourth element for finding Bullock collaterally estopped from relitigating the Illinois determination, is also satisfied. The court finds no error in the Bankruptcy court's finding of



collateral estoppel barring Bullock from reopening the finding of breach of fiduciary duties.

Bullock next complains that the Bankruptcy Court failed to consider his affirmative defenses. He asserts that the Appellee has wrongfully and unreasonably refused to allow his assets to be used toward the satisfaction of the state court judgment. Appellant's brief, at 11, 19. Because the Illinois court awarded a constructive trust over property of Bullock, Bullock is unable to liquidate those assets without the approval and cooperation of Appellee. According to Bullock, the Appellee has wrongfully withheld this consent, in violation of its fiduciary duties to the beneficiaries of the trust (which includes the Appellant). *Id.*, at 19. Furthermore, Bullock is correct that the Bankruptcy court failed to consider the effect of Appellee's refusal to allow Bullock to liquidate the assets he has to satisfy the debt it deemed non-dischargeable.

The Appellee responds that the fact that the state court granted the Trust a security interest in the debtor's property does not create an affirmative obligation on the Trust to liquidate that collateral. Appellee's response, at 15. Naturally, Bullock asserts without liquidating the collateral, he cannot satisfy the judgment. Without the consent of the Appellee, he cannot liquidate the collateral. The court finds the parties to this action have created a scenario akin to trying to determine whether the chicken or egg came first.

Unfortunately, it further raises questions of the propriety of Appellee's actions since obtaining the constructive trust, not an issue of the enforceability or dischargeability of the judgment. Given the conclusion that Bullock continues to owe this debt to the Trustee, what obligation does the Appellee, as

Trustee, have to replace those funds into the trust through the most expedient means possible? Surely, when the Illinois Court permitted Trustee a constructive trust on Bullock's assets, it was not for the purpose of a lien in perpetuity. Rather, the sale of collateral to repay a debt is the general purpose for granting a security interest in collateral in the first place. If the collateral is sold and the debt repaid, that the lienholder no longer needs the security interest. Preventing the sale of the collateral perpetuates the lien but prevents payment of the debt. Even the case cited by Appellee in support of its statement that "the only way in which a money judgment can be satisfied is by payment in money unless the parties agree otherwise" (Appellee brief at 14), recognizes that holding collateral hostage in perpetuity is impermissible. See *Heller v. Lee*, 474 N.E. 2d 856, 858 (Ill.App.Ct. 1985). In *Heller*, the court stated

The plaintiffs contend that they took the property as security for eventual cash payment of the judgment. We agree. But, as matters now stand, the plaintiffs can sit on the property indefinitely and institute supplemental proceedings to recover the rest of the judgment. Thus the plaintiffs have the use and enjoyment of a valuable piece of property while the defendants, who put the property up as bond expecting it to satisfy the judgment, are not only deprived of the property, but may also be compelled to dig even deeper in order to pay the judgment. Such a result is inequitable. The plaintiffs have received a windfall at the defendants' expense. If, as the plaintiffs contend, the transfer of the real estate was intended to secure the judgment, then by taking the deed, the plaintiffs acquired only a lien. Rather than proceed against the defendants



to recover the judgment, the equitable solution is for the plaintiffs to foreclose on their lien by selling the property.

We are guided in this result by the maxim that equity regards as done that which ought to be done. The parties intended the property to secure the judgment. Therefore, the property should be used to satisfy the judgment.

*Heller v. Lee*, 474 N.E.2d 856, 858 (Ill.App.Ct.1985). More recently, another Illinois court also held

Those contractual rights as to the collateral, however, are limited by equitable principles, which do not allow a creditor to forever sit on collateral, seek alternative relief, and have the use of the collateral, which the debtor expected would satisfy the obligation, to the debtor's hardship. *See Heller v. Lee*, 130 Ill.App.3d 701, 703, 85 Ill.Dec. 896, 474 N.E.2d 856, 858 (1985); *see also* Restatement (Third) of Suretyship & Guaranty § 51(2)(b) (1996) (a creditor may be required to liquidate collateral to satisfy a debt when to do otherwise would cause undue hardship).

*International Supply Co. v. Campbell*, 907 N.E.2d 478, 488 (Ill.App.Ct.2009).

While this court is convinced Appellee is abusing its position of trust by failing to liquidate the assets, this issue is not properly before this court, but rather should brought by Bullock in an action in Illinois to consider the malfeasance of the trustee.

## CONCLUSION

Having considered the arguments of the parties, the court finds that the decision of the Bankruptcy Court is due to be affirmed. The court therefore

28a

**ORDERS** that the Order of the Bankruptcy Court will be **AFFIRMED** by separate Order.

**DONE** and **ORDERED** this the 22nd day of March, 2011.

/s/ Inge Prytz Johnson  
**INGE PRYTZ JOHNSON**  
**U.S. DISTRICT JUDGE**

**APPENDIX D**

**UNITED STATES BANKRUPTCY COURT  
FOR THE NORTHERN DISTRICT OF ALABAMA  
NORTHERN DIVISION**

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**CASE NO. 09-84300-JAC-7  
CHAPTER 7  
A.P. No. 10-80003-JAC-7**

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**In the Matter of: RANDY CURTIS BULLOCK  
SSN: XXX-XX-2223**  
*Debtor(s).*

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**BANKCHAMPAIGN, N.A., as Successor Trustee of the  
Curt Bullock Trust No. 2,**  
*Plaintiff(s),*  
**v.**  
**RANDY CURTIS BULLOCK,**  
*Defendant(s).*

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**MEMORANDUM OPINION**

This matter is before the Court on BankChampaign's motion for summary judgment on its complaint to determine the dischargeability of a state court judgment entered against the debtor, Randy Bullock ("Bullock"), in the Circuit Court of Illinois of Vermilion County, Danville Illinois. For the reasons set for below, the Court finds that the debtor is collaterally estopped from attacking the Illinois court's judgment because the issues determined by the state court are the same as the issues arising under 11 U.S.C. § 523(a)(4).

## **I. BACKGROUND**

On June 11, 2002, the Illinois court entered a memorandum opinion and order granting summary judgment in favor of BankChampaign. The court determined that Bullock breached his fiduciary duty by self-dealing while serving as trustee of a living trust. After a subsequent trial on the issue of damages, the Illinois court entered an order dated December 22, 2002 awarding damages in favor of BankChampaign against Bullock in the amount of \$250,000, plus attorney fees in the amount of \$35,000 based on Bullock's breach of fiduciary duty. The damages awarded represented the benefits Bullock received from his breaches of fiduciary duty.

On October 21, 2009, Randy Bullock filed for bankruptcy relief in this Court under Chapter 7 of the Bankruptcy Code. On January 11, 2010, BankChampaign filed this complaint to determine dischargeability of the judgment debt owed to the bank pursuant to § 523(a)(4). BankChampaign seeks summary judgment based on the doctrine of collateral estoppel by applying the findings of fact and conclusions of law made by the Illinois court to the elements of its § 523(a)(4) claim in this adversary proceeding as a debt for "fraud or defalcation while acting in a fiduciary capacity[.]" 11 U.S.C. § 523(a)(4).

## **II. STANDARD FOR SUMMARY JUDGMENT**

Pursuant to Federal Rule of Civil Procedure 56(c) and Federal Rule of Bankruptcy Procedure 7056, summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as

a matter of law.” *Gray v. Manklow (In re Optical Tech., Inc.)*, 246 F.3d 1332, 1334 (11th Cir. 2001) (quoting *Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 2552 (1986)). “In making this determination, the court must view all evidence and make all reasonable inferences in favor of the party opposing summary judgment.” *In re Optical Tech, Inc.*, 246 F.3d at 1334 (11th Cir. 2001) (quoting *Chapman v. A1 Transp.*, 229 F.3d 1012, 1023 (11th Cir. 2000)). “Where the record taken as a whole could not lead a rational trier of fact to find for the non-moving party, there is no ‘genuine issue for trial.’” *In re Optical Tech, Inc.*, 246 F.3d at 1334 (11th Cir. 2001) (quoting *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 587 (1986)). “[A] bankruptcy court deciding a summary judgment motion . . . must determine whether there are any genuine issues of material fact.” *In re Optical Tech, Inc.*, 246 F.3d at 1334.

“When a party seeks summary judgment based on the doctrine of collateral estoppel, the nonmoving party may not defeat the motion simply by establishing that it has evidence that conflicts with the factual conclusions of the trier of fact in the previous case. Even if the nonmoving party produces evidence that contradicts a prior judgment, collateral estoppel bars the party from relitigating facts decided in the previous case.” *Southern California Gas Co. v. Collier (In re Collier)*, 2010 WL 1241778, at \*2 (Bankr. N.D. Ill. 2010); *Multiut Corp. v. Draiman (In re Draiman)*, 2006 WL 1876972, at \*4 (Bankr. N.D. Ill 2006). While the movant bears the burden of showing that collateral estoppel applies in the first instance, the non-moving party may oppose the motion by arguing that the movant has not satisfied each of the elements of collateral estoppel. *Id.*



### III. STANDARD FOR COLLATERAL ESTOPPEL

The doctrine of collateral estoppel or issue preclusion refers to the effect of a judgment in foreclosing the relitigation of a matter that has already been litigated and decided. *Quinn v. Monroe County*, 330 F.3d 1320, 1328 (11th Cir. 2003); *See St. Laurent, v. Ambrose (In re St. Laurent)*, 991 F.2d 672, 675 (11th Cir. 1993) ("Collateral estoppel, or issue preclusion bars relitigation of an issue previously decided in judicial or administrative proceedings . . ."). "A bankruptcy court may rely on collateral estoppel to reach conclusions about certain facts, foreclose relitigation of those facts, and then consider those facts as 'evidence of nondischargeability.'" *Thomas v. Loveless (In re Thomas)*, 288 Fed. Appx. 547, at \*1 (11th Cir. 2008). While collateral estoppel may bar a bankruptcy court from relitigating the factual issues previously decided in another judicial proceeding, "the ultimate issue of dischargeability is a legal question to be addressed by the bankruptcy court in the exercise of its exclusive jurisdiction to determine dischargeability." *In re St. Laurent*, 991 F.2d at 675.

The Eleventh Circuit gives "preclusive effect to the judgment of a state court provided that two conditions are met: (1) the courts of the state from which the judgment emerged would do so themselves; and (2) the litigants had a full and fair opportunity to litigate their claims and the prior state proceedings otherwise satisfied the applicable requirements of due process." *Quinn*, 330 F.3d at 1329. "If the prior judgment was rendered by a state court, then the collateral estoppel law of that state must be applied to determine the judgment's preclusive effect." *In re St. Laurent*, 991 F.2d at 675-676. Under Illinois law,



the following elements must be established before collateral estoppel may be invoked:

- (1) the issue decided in the prior litigation was identical to the current one;
- (2) there was a final judgment on the merits;
- (3) the party against whom estoppel is asserted was a party to the prior action or in privity with it; and
- (4) the factual issue at stake has actually and necessarily been litigated and determined in the prior action.

*Multiut Corp. v. Draiman (In re Draiman)*, 2006 WL 1876972, at \*4 (Bankr. N.D. Ill 2006). When a party seeks to bar the relitigation of certain facts decided in a prior action, a court “must carefully review the prior judgment to determine whether the factual or legal issue at issue in the later proceeding was in dispute and finally resolved in the earlier proceeding.” *Id.*

#### IV. ILLINOIS COURT’S FINDINGS

The suit filed by BankChampaign in the Illinois state court sought a determination that Bullock’s actions as the trustee of an irrevocable living trust known as the Curt Bullock Trust No. 2, a trust established by the debtor’s father, constituted a breach of his fiduciary duty not to self-deal. The Illinois court issued an opinion granting summary judgment in favor of the beneficiaries of the trust, finding in part as follows:

- (1) In December of 1978, Bullock’s father created an irrevocable living trust and named Bullock as the trustee. The sole asset of the trust was a life insurance policy on the life of the debtor’s father.

(2) Bullock borrowed funds against the cash value of the life insurance policy on three occasions and loaned the proceeds to his mother and to business entities in which he had an interest. Bullock and his mother used the money to repay a debt owed by Bullock's mother and to purchase real estate.

(3) Bullock lent money to entities in which he had a financial interest or to relatives which clearly placed him in a position where he would be tempted to act in his interest and possibly against the interest of the beneficiaries.

(4) Bullock placed himself in a position of conflict with the beneficiaries.

(5) The trust did not earn any profits on the loans.

(6) Bullock "was clearly involved in self-dealing and no exception to the prohibition against self-dealing is applicable." Memorandum and Order, p. 2.

(7) The loans made by Bullock while acting as trustee were self-dealing transactions as all of the loans were made to entities Bullock had a financial interest in or were made to a relative.

(8) Bullock's act of self-dealing constituted a breach of the defendant's fiduciary duty while acting as a trustee.

(9) The loans were self-dealing and Bullock failed to produce any evidence to show that an exception to the prohibition against self-dealing applied in the case.

(10) Summary judgment was not appropriate on plaintiff's contention that Bullock breached his fiduciary duty by constructive fraud because Bullock claimed that he acted in good faith.

(11) Although Bullock did not appear to have had a "malicious motive" in borrowing funds from the trust, the state court affirmatively found that neither the facts nor the circumstances surrounding the loans nor Bullock's motives excused him from liability. There was a clear breach of the Bullock's fiduciary duty entitling the plaintiffs to damages.

(12) The court concluded that the plaintiffs were entitled to an award of \$250,000 plus attorney fees based on the benefit received by Bullock from the breaches he committed. The fact that Bullock had in fact repaid the loans did not excuse his conduct.

## V. APPLICATION OF ILLINOIS' COLLATERAL ESTOPPEL STANDARDS

### 1. IDENTITY OF ISSUES

While the bankruptcy court must look to the law of the state that issued the judgment at issue to determine whether the elements of collateral estoppels are satisfied, the ultimate issue of dischargeability is matter of federal law. *Southern California Gas Co. v. Collier (In re Collier)*, 2010 WL 1241778 (Bankr. N.D. Ill. 2010); *See also In re St. Laurent*, 991 F.2d at 676. Section 523(a)(4) of the Bankruptcy Code excepts from discharge any debt for "fraud or defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). Before the Court can find a debt nondischargeable for fraud or defalcation under this exception, the Court must find that: (1) a fiduciary relationship existed between the debtor and creditor; and that (2) the debtor committed fraud or defalcation in the course of that fiduciary relationship. *Hosey v. Hosey (In re Hosey)*, 355 B.R. 311, 321 (Bankr. N.D. Ala. 2006); *Bookbinder v. Pleeter (In re Pleeter)*, 293 B.R. 812, 815 (S.D. Fla. 2003); *Eavenson v. Ramey (In*

*re Eavenson*), 243 B.R. 160, 164 (N.D. Ga. 1999). In *Grogan v. Garner*, 498 U.S. 279 (1991), the Supreme Court held that the standard of proof to be applied in all dischargeability proceedings under § 523(a) is the preponderance of the evidence standard.

To prove breach of fiduciary duty in Illinois, a plaintiff must establish: (1) a fiduciary duty on the part of the defendant; (2) the defendant's breach of that duty; and (3) damages that were proximately caused by the defendant's breach. *DOD Technologies v. Mesirow Ins. Services, Inc.*, 887 N.E.2d 1, 6 (1st Dist. 2008). The burden of pleading the existence of a fiduciary relationship lies with the party seeking relief to establish same by clear and convincing evidence. *See Hensler v. Busey Bank*, 596 N.E.2d 1269, 1275 (4th Dist. 1992). The burden of proof by clear and convincing evidence standard "is more exacting than the 'preponderance of the evidence' standard[.]" *Jove Engineering, Inc. v. Internal Revenue Service (In re Jove)*, 92 F.3d 1539, 1545 (11th Cir. 1996).

### FIDUCIARY CAPACITY

The term "fiduciary" has traditionally been defined as a special relationship of confidence, trust, and good faith, but most courts have found this definition to be far too broad for purposes of § 523(a)(4). The Eleventh Circuit has discussed the definition of fiduciary capacity under § 523(a)(4) in *Quaif v. Johnson (In re Quaif)*, 4 F.3d 950, 953-54 (11th Cir. 1993) and *Guerra v. Fernandez-Rocha (In re Fernandez-Rocha)*, 451 F.3d 813, 816 (11th Cir. 2006) and explained in both cases that the exception to dischargeability is to be narrowly construed. The Eleventh Circuit most recently explained the breadth of the term fiduciary for purposes of § 523(a)(4) as follows:



In *Quaif*, this Court further noted that the 1934 *Davis* decision is the last Supreme Court case to speak to the issue and that the Supreme Court has left “the lower courts to struggle with the concept of ‘technical’ trust.” *Quaif*, 4 F.3d at 953. *Quaif* also discussed the trends in judicial interpretation of the § 523(a)(4) exception and noted that courts seemed to include the **voluntary, express trust created by contract** within the scope of “fiduciary capacity” as used in § 523(a)(4). In contrast, courts have excluded the involuntary resulting or constructive trust, created by operation of law, from the scope of the exception. *Id.* Additionally, *Quaif* noted that cases have “also articulated a requirement that the trust relationship have existed prior to the act which created the debt in order to fall within the statutory [fiduciary capacity] exception.” Accordingly, “constructive” or “resulting” trusts, which generally serve as a remedy for some dereliction of duty in a confidential relationship, do not fall within the § 523(a)(4) exception “because the act which created the debt *simultaneously* created the trust relationship.” *Id.*

*In re Fernandez-Rocha*, 451 F.3d at 816. (emphasis added).

In *Quaif*, the Eleventh Circuit determined that a Georgia insurance statute created a technical trust for purposes of § 523(a)(4), while the court determined that a Florida physician licensing statute did not create a technical trust in *Fernandez-Rocha*. In this case, Bullock’s fiduciary duty as trustee of the Curt Bullock Trust No. 2 arose under an express trust agreement entered into voluntarily by contract for purposes of § 523(a)(4). The Illinois court found



that Bullock's father created an irrevocable living trust naming Bullock as trustee and further found Bullock liable for breach of his fiduciary duties while serving as trustee of same. The state court's findings clearly establish that Bullock owed a fiduciary duty to BankChampaign for purposes of § 523(a)(4) as the trustee of an express trust. Accordingly, BankChampaign has established that collateral estoppel applies for purposes of determining whether a fiduciary relationship existed between BankChampaign and Bullock.

### FRAUD OR DEFALCATION

BankChampaign argues that the issues decided by the state court are identical to the issue before this Court of whether Bullock committed fraud or defalcation. Bullock counters that collateral estoppel cannot apply to establish defalcation for purposes of § 523(a)(4) because the state court opinion did not specifically use the term "defalcation." The state court judgment need not, however, have specifically used the term "defalcation" for collateral estoppel to apply. *Multiut Corp. v. Draiman (In re Draiman)*, 2006 WL 1876972, at \*5 (Bankr. N.D. Ill 2006) (finding previous court need not have used the word "malicious" for collateral estoppel to apply in a § 523(a)(6) determination). Instead, this Court must closely review the state court decision to determine whether the factual or legal issues that are currently before this Court were in dispute and finally resolved in the state court proceeding. *In re Collier*, 2010 WL 1241778, at \*2.

While the term defalcation generally refers to a failure to produce funds entrusted to a fiduciary, the Eleventh Circuit has observed that the "best analysis of 'defalcation' is that of Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d

510 (2d Cir.1937), in which 'Judge Hand concluded that **while a purely innocent mistake by the fiduciary may be dischargeable, a 'defalcation' for purposes of this statute does not have to rise to the level of 'fraud,' embezzlement,' or even 'misappropriation.'**" *In re Fernandez-Rocha*, 451 F.3d at 817 (quoting *In re Quaif*, 4 F.3d at 955 (citing *Central Hanover*, 93 F.2d at 512)). Indeed, the court of appeals observed that that "[s]ome cases have read the term even more broadly, stating that **even a purely innocent party can be deemed to have committed a defalcation for purposes of § 523(a)(4).**" *Id.* (emphasis added.) The term defalcation has been further defined by courts in the Eleventh Circuit to include a **"fiduciary's failure to account for funds due to any breach of duty whether it was intentional, willful, reckless, or negligent. Proof of fraud is not even needed."** *Fish v. Sadler (In re Sadler)*, 2007 WL 4199598, at \*2 (Bankr. N.D. Fla. 2007) (emphasis added).

In *McDowell v. Stein (In re McDowell)*, 415 B.R. 584 (S.D. Fla. 2009), a Florida District Court found that a state court judgment debt arising from a debtor's breach of fiduciary duty by self-dealing fell within the discharge exception for defalcation under § 523(a)(4). The district court found that the debtor's self-dealing and exclusion of the rightful owners from the use and operation of a company formed by the parties as equal co-owners resulted in the wrongful withholding of funds from the rightful owners for purposes of § 523(a)(4) where the debtor's conduct rose "above a purely innocent mistake" and constituted "a failure to produce funds entrusted to a fiduciary." *In re McDowell*, 415 B.R. 584, 598 (S.D. Fla. 2009). To the extent the state court imposed damages for breach of fiduciary duty, the district court deter-

mined that the debt was non-dischargeable under § 523(a)(4).

Here the state court found that Bullock, while acting in a fiduciary capacity, lent monies or misappropriated funds held in Bullock's fiduciary capacity to entities in which he had a financial interest or to relatives which clearly placed Bullock in a position where he would be tempted to act in his own interest and possibly against the interest of the trust beneficiaries; Bullock placed himself in a position of conflict with the trust beneficiaries; Bullock was clearly involved in self-dealing; and Bullock's self-dealing constituted a breach of his fiduciary duty as trustee. Additionally, the court determined that Bullock failed to produce any evidence that an exception to the prohibition against self-dealing applied. The state court further accounted for the fact that Bullock had repaid the misappropriated funds to the trust when the court calculated BankChampaign's damages. Despite the fact that Bullock had shown a willingness to repay the loans, the state court found that BankChampaign was entitled to an award of \$250,000, plus attorney fees, based on the benefit Bullock received from his breach of fiduciary duty. The findings of fact and conclusions of law entered by the Illinois state court are clearly sufficient to establish defalcation for purposes of § 523(a)(4). Bullock's conduct, i.e Bullock's use of trust funds to make loans to entities in which he had a financial interest or to relatives, was certainly not unintentional, nor a purely innocent mistake. Bullock intentionally misappropriated trust assets and by doing so placed himself in a position of conflict with the trust beneficiaries. Accordingly, to the extent the Illinois court imposed damages for breach of fiduciary duty by self-dealing, such debt is non-dischargeable under

§ 523(a)(4) as a debt for defalcation while acting in a fiduciary capacity.

Alternatively, the Court finds that the state court judgment supports a findings of fraud while acting in a fiduciary capacity for purposes of § 523(a)(4). Under Illinois law, a breach of fiduciary duty by self-dealing is fraudulent. *Maksym v. Loesch*, 937 F.2d 1237, 1241 (7th Cir. 1991) ("self-dealing in the course of a fiduciary relationship is . . . a form of fraud."). While Bullock concedes that the Illinois court found that he breached his fiduciary duty to BankChampaign by self-dealing, Bullock argues that the state court judgment specifically denied BankChampaign's motion for summary judgment on the issue of constructive fraud and further argues the presumption that self-dealing by a fiduciary is fraudulent is a rebuttable presumption. While the Illinois court refused to grant summary judgment in favor of BankChampaign on the issue of whether Bullock breached his fiduciary duty by constructive fraud, the state court did specifically find breach of fiduciary duty based on self-dealing which raises a presumption of fraud under Illinois law. Moreover, the state court specifically found that Bullock failed to raise any facts that would suggest that an exception to the finding of breach of fiduciary duty by self-dealing applied.

To state a claim for common law fraud in Illinois, "a plaintiff must allege that any misrepresentations were: (1) a false statement of material fact; (2) known or believed to be false by the party making them; (3) intended to induce the other party to act; (4) acted upon by the other party in reliance upon the truth of the representations; and (5) damaging to the other party as a result." See *Cwikla v. Sheir*, 801 N.E.2d 1103, 1110-111 (1 Dist. 2003). Similarly, to prove



fraud under § 523(a)(4), the plaintiff must prove that: (1) the debtor made a representation; (2) the debtor knew the representation was false; (3) the debtor made a false representation with intention and purpose of deceiving the creditor; (4) creditor relied upon the debtor's representation; and (5) the creditor suffered loss or damage as the proximate result of the representation. *In re Wells*, 368 B.R. 506, 514 (Bankr. M.D. La. 2006). In Illinois, the elements of fraud must be proven by clear and convincing evidence which is a higher standard than required for establishing the elements of fraud by a preponderance of the evidence for purposes of § 523(a)(4). *Cwikla v. Sheir*, 801 N.E.2d at 1110-111. Accordingly, the Court finds that the finding of breach of fiduciary duty by self-dealing which is a form of fraud in Illinois supports a finding of fraud for purposes of § 523(a)(4).

## **2. FINAL JUDGMENT ON THE MERITS AND PARTY TO THE ACTION**

The Court further finds that the state court judgment satisfies the second and third elements of collateral estoppel under Illinois law. The judgment was a final decision on the merits to which Bullock was a party. The state court resolved all of the issues before it and entered damages in favor of BankChampaign based on Bullock's breach of fiduciary duty by self-dealing.

## **3. ACTUALLY AND NECESSARILY LITIGATED**

Bullock argues that the judgment is not entitled to collateral estoppel effect because the state court entered the judgment on summary judgment without a trial. An order entered based on summary judg-



ment does, however, satisfy the actually litigated element of collateral estoppel. *Brown v. Manty (In re Brown)*, 2010 WL 1286078 (D. Minn. 2010) (finding debtor's invocation of Fifth Amendment did not prevent judgment that was entered by state court at summary judgment stage of the proceedings from having collateral estoppel effect in later § 523(a)(4) proceeding where the debtor participated and opposed plaintiff's motion for summary judgment and the state court then carefully considered the record and concluded that there was no genuine issue of fact); *See also Little v. Tapscott*, 2002 WL 1632519, at \*8 (N.D. Ill. 2002) ("A granting of summary judgment operates to bar the cause of action for purposes of issue preclusion."); *Union Fed. Sav. and Loan Ass'n v. Champion Federal*, 557 N.E. 2d 950, 952 (Ill. App. 3 Dist. 1990) (summary judgment is the procedural equivalent of a trial and is an adjudication of the claim on the merits for purposes of collateral estoppel). Bullock was represented by counsel in the state court litigation and fully participated in the action. Accordingly, the state court judgment satisfies the actually and necessarily litigated element for purposes of collateral estoppel.

## VI. CONCLUSION

Bullock is barred from re-litigating the issue of breach of fiduciary duty by fraud or defalcation for purposes of § 523(a)(4). The state court judgment which found that Bullock misappropriated trust assets by self-dealing and breached his fiduciary duties while acting as a trustee falls within the discharge exception for fraud or defalcation while acting in a fiduciary capacity. The issues determined by the Illinois court in the prior lawsuit finding that Bullock breached his fiduciary duty by self-dealing

were the same for purposes of Illinois's doctrine of collateral estoppel as the issues arising in this adversary proceeding to discharge the resulting debt for "fraud or defalcation while acting in a fiduciary capacity" under § 523(a)(4). The Illinois court's judgment is nondischargeable.

A separate order will be entered consistent with this opinion.

DONE and ORDERED this date: May 27, 2010.

/s/ Jack Caddell  
Jack Caddell  
United States Bankruptcy Judge

**APPENDIX E**

**IN THE CIRCUIT COURT FOR THE  
FIFTH JUDICIAL CIRCUIT OF ILLINOIS  
VERMILION COUNTY, DANVILLE, ILLINOIS**

[Filed Dec. 23, 2002]

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Case No. 99-CH-34

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DAVID S. BULLOCK, *et al.*,  
Plaintiffs,

vs.

RANDALL C. BULLOCK, *et al.*,  
Defendants.

---

**ORDER**

The Court has already determined that the Defendant, while acting as trustee, breached his fiduciary duties. The only issue remaining is what damages are available to the Plaintiffs for these breaches.

The Defendant in this case does not appear to have had a malicious motive in borrowing funds from the trust. Up until the time the first loan was made by the Trust, the evidence shows that the Defendant was unaware of the existence of the Trust or of his position as trustee. The first loan was taken at the request of the Defendant's father, who was also the settlor of the Trust, for the benefit of the Defendant's mother. The evidence shows the Plaintiffs were unaware of the existence of the Trust at that time. The Defendant has shown his willingness to make the Trust whole by a pattern of payments he has made to repay the loans from the Trust. The evidence shows the loans have been, in fact, repaid in full.

However, neither the facts and circumstances surrounding the loans nor the motives of the Defendant can excuse him from liability. There has been a clear breach of the Defendant's fiduciary duty, and the Plaintiffs are entitled to damages. The Defendant has suggested two different approaches for measuring damages. The first approach relies on the value of the Trust had the Defendant opted to convert the interest paid to a variable rate policy. This measure of damages is inappropriate. It has no relation to the actual breaches of trust committed by the Defendant. There has been no suggestion, nor any evidence, to say that the Defendant breached his fiduciary duties by failing to convert the policy. The investment decisions of a trustee are governed by the prudent investor rule. While hindsight may show that had the Defendant chosen to invest the Trust assets differently he may have reaped a greater return for the Trust, there is nothing to establish that the Defendant's choice was not acceptable under the prudent investor rule. Given the lack of evidence showing the decision not to convert the policy was imprudent and the lack of any connection with the actual breaches committed by the Defendant, the hypothetical value of the policy had it been converted to a variable rate policy is not an appropriate measure of damages.

The other alternative suggested is the benefit received by the Defendant from breaches he committed. The actual monetary benefit received by the Defendant from the inappropriate loans is difficult to ascertain. However, a court in equity has broad power to fashion a remedy that will produce an equitable outcome. The Court has considered the fact that the Defendant has, in fact, repaid the loans in computing the damages awarded to the Plaintiffs. But that cannot completely excuse the Defendant's conduct.

Therefore, IT IS HEREBY ORDERED as follows:

- A. As to Count I of the Second Amended Complaint against Defendant Randy Bullock, judgment is rendered against the Defendant and in favor of the Plaintiffs, and Defendant Randy Bullock is ordered to pay the Trust \$250,000.00 to represent the benefits he received from his breaches. The Defendant is also ordered to pay the Trust the sum of \$35,000.00 for attorney's fees and litigation costs, which shall be used to reimbursement to the Plaintiffs for their attorneys' fees and litigation costs in accordance with paragraph E below. The Defendant has 365 days to pay this judgment or as ordered by the Court. Interest at the rate of six percent (6%) per annum, shall accrue on any unpaid portion of this judgment award from the date of this order until paid in full.
- B. As to Count II of the Second Amended Complaint against Defendants Randy Bullock, Curt Bullock Builders, Inc. 101381) and American Builders Financial Corporation (ABFC) a constructive trust against their assets is awarded in the same amount as the total monetary judgment rendered against Defendant Randy Bullock in Count I. Given that the mill located in Springfield, Ohio, was the first property acquired through the wrongful use of Trust property, this Court holds that the Defendants do not hold any equity in that property. A constructive trust is therefore specifically placed on the mill that will act as a lien against it and as security for the money judgment awarded to the



Trust under Count I above. ABFC, and any other Defendant who has a legal interest in the mill, is ordered to make a Mortgage on that property in favor of "Trustee of the Curt Bullock Trust No. 2 dated December 19, 1978" as evidence of this constructive trust award and to record it in the Clark County, Ohio, Recorder's office. In addition, a constructive trust is specifically placed upon the beneficial interest of Randy Bullock in the Trust. When the monetary judgment of Count I is paid in full by Defendant Randy Bullock, this constructive trust shall be deemed satisfied in full and thereby dissolved.

- C. As to Count III of the Second Amended Complaint, given the awards made on Counts I and II above, count III is rendered moot.
- D. The Defendant's Cross-Complaint against BankChampaign, NA, as current Trustee of the Trust, is denied.
- E. As to the Plaintiffs' petition for an award of attorney's fees, BankChampaign NA as Trustee of the Trust should reimburse the Plaintiffs for attorneys' fees and litigation costs as this lawsuit was for the benefit of the common fund. Illinois law has long held that if a party, having a common interest in a trust fund, takes proper proceedings to save it from destruction and restore it to the purposes of the trust, then that party is entitled to an award of attorney fees out of the fund itself. *State Life Insurance Co. v. Board of Education of Chicago*, 401 111.252, 81 N.E.2d 877 (1948); *Rennacker v. Rennacker*, 156 111.App.3d 712, 509 N.E.2c1798, 109 Ill. Dec. 137 (3rd Dist.

1987); *Brown v. Commercial National Bank of Peoria*, 94 111.App.2d 273, 237 N.E.2d 567 (3rd Dist, 1968). The amount of reimbursement from the Trust shall be \$25,000.00.

ENTERED this 22 day of December, 2002.

/s/ Thomas J. Fahey  
Thomas J. Fahey  
Circuit Court Judge

**APPENDIX F**

**IN THE CIRCUIT COURT FOR THE  
FIFTH JUDICIAL CIRCUIT OF ILLINOIS  
VERMILION COUNTY, DANVILLE, ILLINOIS**

[Filed June 11, 2002]

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Case No. 99-CH-34

---

DAVID S. BULLOCK, *et al.*,  
*Plaintiffs,*

vs.

RANDALL C. BULLOCK, *et al.*,  
*Defendants.*

---

**MEMORANDUM AND ORDER**

In December 1978 Curt Bullock created an irrevocable living trust, "Curt Bullock Trust No. 2." The Defendant was named as the trustee and Defendant and Plaintiffs were named as beneficiaries of the trust. The sole asset of the trust was a life insurance policy on the life of Curt Bullock. The Defendant borrowed against the cash value of the life insurance policy on three occasions. He then loaned the proceeds to his mother and to business entities he had an interest in. They used the money to repay a debt owed by his mother and to purchase real estate. Defendant made these loans at the same interest rate the trust was charged for borrowing from the life insurance policy. The trust did not earn any profit on the loans. The Defendant claims all loans have been repaid.

The Plaintiffs have moved for partial summary judgment on Count I of the Second Amended Com-

plaint, alleging that Defendant is liable for a number of breaches of his fiduciary duty as trustee of the Curt Bullock Trust No. 2.

### **ISSUES PRESENTED**

1. Is summary judgment appropriate on Plaintiffs' contention that Defendant breached his fiduciary duty by failing to ascertain the trust res, beneficiaries, and duties as trustee?
2. Is summary judgment appropriate on Plaintiffs' contention the loans made by the Defendant, acting as trustee, breached the provisions of the trust?
3. Is summary judgment appropriate on Plaintiffs' contention that Defendant breached his fiduciary duty by self-dealing with trust assets?
4. Is summary judgment appropriate on Plaintiffs' contention that Defendant breached his fundamental fiduciary duty to avoid conflicts of interest?
5. Is summary judgment appropriate on Plaintiffs' contention that Defendant breached his fiduciary duty by constructive fraud?
6. Is summary judgment appropriate on Plaintiffs' contention that Defendant breached his fiduciary duty by failing to make an accounting of the trust?

### **BRIEF ANSWERS**

1. Yes. No material facts are in dispute. The Defendant had a duty to ascertain the trust res, beneficiaries, and his duties as trustee. Defendant was under a duty to read and

became bound by the trust document when he signed it.

2. No. Defendant claims he made the loans pursuant to his broad powers to reinvest the trust assets, thus creating a material issue of fact.
3. Yes. Defendant was clearly involved in self-dealing and no exception to the prohibition against self-dealing is applicable.
4. Yes. It is undisputed that Defendant put himself in a position in conflict with the interests of the beneficiaries.
5. No. There were no transactions between the parties. Even if there were, Defendant claims he acted in good faith.
6. Yes. Any reasonable interpretation of the statute requires the Defendant to make an accounting. It is undisputed that the Defendant failed to make such an accounting.

### ANALYSIS

#### Issue 1

Case law supports Plaintiffs' claim that Defendant, after his appointment as trustee, had a duty to promptly ascertain the trust res, beneficiaries, and his duties. *Bullis v. DuPage Trust Company*, 72 Ill. App. 3d 927, 391 N.E. 2d 227, 31 (2nd Dist. 1979). Defendant does not dispute a trustee has certain duties after accepting the position. However, Defendant claims that he was unaware he was the trustee until 1981, three years after the trust was executed. Defendant claims he has no knowledge of signing the trust document, and his father, the settlor of the trust, does not recall the circumstances surrounding



its creation. Defendant admits the signature on the trust document appears to be his, and he does not allege any fraud or misrepresentation to induce his signature. His only claim is that around the time the trust was executed he would come to Danville from Ohio every couple of months and sign a number of documents given to him by the comptroller of Curt Bullock Builders, Inc.

After 1981 there is no dispute that Defendant was aware he was the trustee, and there is no evidence that he ascertained the trust res, beneficiaries, or his duties. Prior to 1981, the only issue in dispute is whether Defendant had accepted the position of trustee in spite of his claims of ignorance. It is a general principle that one cannot avoid the effects of an instrument on the grounds that the signer was ignorant of its contents, where the ignorance is due to the signer's negligence. *Flannery v. Flannery*, 320 Ill. App. 421, 51 N.E.2d 349, 353 (4th Dist. 1943). The rule in this state has long been that a person has a duty to read contracts before signing them. *Mt. Zion State Bank & Trust v. Weaver*, 226 Ill. App. 3d 783, 589 N.E.2d 983, 986 (4th Dist. 1992). Even assuming the comptroller had told him it was a routine business document, the Defendant cannot complain about such a misrepresentation when he had the opportunity to read the document. *Flannery*, 51 N.E.2d at 353. Defendant became the trustee when he signed the document, and thus became subject to the legal obligations of a trustee. There are no material issues of fact on this issue and summary judgment for the plaintiff is GRANTED.

## Issue 2

Plaintiff alleges that Defendant breached the provisions of Article VII of the trust by borrowing money

from the life insurance policy to make loans to his mother and to entities he had an interest in. Article VII of the trust only allows borrowing from the trust in two circumstances, to pay the policy premiums or to satisfy a beneficiary's request for a withdrawal. It is undisputed that the borrowed money was not used in either of those two ways. However, Article VII also gives the trustee broad power and discretion to reinvest trust assets as he sees fit. Defendant claims he made the loans to shift trust assets from what he deemed to be an insurance industry in financial trouble to a less risky investment. There is clearly a disputed issue of material fact as to whether the loans were investments and, therefore, within the trustee's power. Summary judgment is DENIED on this issue.

### Issue 3

It cannot be disputed the loans made by the Defendant while acting as trustee are considered self-dealing transactions. All of the loans were made to entities he had a financial interest in or to a relative. The only question is whether the self-dealing in this case constituted a breach of Defendant's fiduciary duty.

The Plaintiffs cite a number of cases holding that a trustee is prohibited from dealing with trust property for his own benefit, including the loaning of money or leasing of trust property to himself. See, *Dick v. Peoples Mid-Illinois Corp*, 242 Ill. App. 3d 297, 609 N.E.2d 997 (Ill. 1993); *In re Will of Gleeson*, 5111. App. 2d 61, 124 N.E.2d 624 (3rd Dist. 1955); *Campbell v. Albers*, 313 Ill. App. 152, 39 N.E.2d 672 (2nd Dist 1942). The prohibition against self-dealing also prevents a trustee from transacting business on behalf of the trust with entities he has financial

interests in. *Matter of Estate of Allison*, 140 Ill. App. 3d 183, 488 N.E.2d 1035 (3rd Dist. 1986). In addition, using trust assets for the benefit of family members is also considered self-dealing. *Estate of Hawley*, 183 Ill. App. 3d 107, 538 N.E.2d 1220 (5th Dist. 1989).

Defendant correctly points out that the prohibition against self-dealing is not absolute. Courts have recognized two exceptions: where the trust instrument contemplates, creates, or sanctions the conflict of interests; or where the creator has waived the rule of undivided loyalty by expressly giving the trustee authority to act in a dual capacity, or by implication where the creator knowingly places the trustee in a position that might be in conflict with the beneficiaries. *People's Mid-Illinois Corp.*, 242 Ill. App. 3d at 300. However, the Defendant has not alleged any facts that suggest an exception should be applied in this case. Defendant does assert that the trust document does not expressly prohibit self-dealing, but it is permission to self-deal that must be expressly provided for, not a prohibition against it. *Id.*

Defendant cites *Humpa v. Hedstrom*, 345 Ill. App. 289, 102 N.E.2d 686 (1951) and *Conant v. Lansden*, 409 Ill. 149, 98 N.E.2d 773 (1951) for the proposition that self-dealing is not always prohibited. Defendant's reliance on *Humpa v. Hedstrom* is misplaced and erroneous, the case cited dealt only with a reversal of a contempt citation against the trustee for failing to pay back the trust and a finding that the trustee was not liable for interest. The underlying case addressing the merits is *Humpa v. Hedstrom*, 341 Ill. App. 605, 94 N.E.2d 614 (1st Dist. 1950). The court, in fact, found that the trustee breached his fiduciary duty. *Id.* at 620. The real issue in the case was whether an exception to the self-dealing pro-

hibition applied. In that case the trust document expressly allowed the trustee to invest trust assets in bonds and indebtedness of a company the trustee had an interest in, but the court found the loans made by the trustee were not of the type allowed by the trust provisions. *Id.* at 619.

Defendant also is mistaken in claiming *Conant v. Lansden* supports his position. The court did find a loan to a company in which the trustee was involved to be proper. However, the court was not faced with a true self-dealing problem in that case. The trustee had an insignificant ownership interest in the company and the trust itself had a substantial interest in the company. *Conant v. Lansden*, 98 N.E.2d at 778. In the present case, the trust had no interest in any of the entities to which the Defendant lent trust money. The other questionable loan was made to a company the trustee was secretary of. The court noted there was no evidence to show he was a stockholder or that he received any benefit from the company. *Id.* The court did not need to apply self-dealing analysis, and found the loans proper based on the trustee's investment power. *Id.*

Finally, Defendant is incorrect in claiming that *Smith v. First National Bank of Danville*, 254 Ill. App. 3d 251, 624 N.E.2d 899 (4th Dist. 1993) stands for the proposition that some courts follow the "better rule" that self-dealing by a trustee with trust property only raises a presumption of impropriety. *Smith* deals with dealings between the trustee and the trust's beneficiaries, not with a trustee's dealing with trust property. While dealings between a trustee and a trust beneficiary may be redeemed by showing the transactions were fair to the beneficiaries, self-dealing with trust property cannot be.



It is undisputed the loans were self-dealing and the Defendant has produced no evidence to show an exception to the prohibition against self-dealing is applicable to this case. Summary judgment for the Plaintiffs on this issue is GRANTED.

#### Issue 4

Defendant concedes in his response to Plaintiffs' Motion that a trustee must not put himself in a position which would expose him to the temptation to act contrary to his duties as trustee. *Id.* at 719. It is undisputed that Defendant lent money to entities in which he had a financial interest or to relatives. Clearly this placed him in a position where he would be tempted to act in his interest, possibly against the interests of the beneficiaries. Defendant claims only a presumption of impropriety arises and that presumption may be rebutted by evidence the transaction was fair to the beneficiary. Defendant relies on *Matter of the Estate of Allison*, 488 N.E.2d 1035. A fair reading of the case does not support Defendant's interpretation. The court held that even though the trustee acted in good faith, any profits he earned through self-dealing belonged to the trust. *Id.* at 1039.

Defendant has failed to cite any case law establishing that only a presumption of impropriety arises when a trustee puts himself in a position in conflict with the beneficiaries. It is undisputed Defendant placed himself in such a situation, therefore, summary judgment for the Plaintiffs is GRANTED on this issue.

#### Issue 5

Plaintiffs allege that when a fiduciary relationship exists, any transaction between the parties is presumptively fraudulent, only rebuttable by clear and



convincing evidence of good faith. As Defendant points out, there are no transactions between the parties in this case. Even if there were transactions there is a material issue as to whether the Defendant acted in good faith. Summary judgment is DENIED on this issue.

#### Issue 6

Defendant does not deny he failed to make an annual accounting of the trust until approximately 1997, but he does deny he was required to do so. A trustee must, at least annually, furnish any beneficiary entitled to receive income from the trust with an accounting detailing the receipts, disbursements, and inventory of the trust. 760 ILCS 5/11(a) (West 1998). Defendant argues the statute is not applicable because there were no beneficiaries entitled to receive income from the trust. That interpretation is patently incorrect. Article VII of the trust expressly allows the beneficiaries to withdraw \$3000 annually. Defendant argues that in the alternative, even if the statute does apply there was nothing to account for, so an accounting was unnecessary. Defendant does not dispute that he borrowed money from the life insurance policy and then loaned it out. This clearly is a transaction that must be accounted for. In addition, the Plaintiffs point out that premiums were paid on the policy and that it was a whole life policy that accumulated value. The only dispute is the interpretation of the statute, which is a legal issue. Summary judgment for Plaintiffs on this issue is GRANTED.

ENTERED this 11 day of June, 2002.

/s/ Thomas J. Fahey  
THOMAS J. FAHEY  
Circuit Court Judge

# **OPPOSITION BRIEF**

**In The  
Supreme Court of the United States**

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**RANDY CURTIS BULLOCK,**

*Petitioner,*

**v.**

**BANKCHAMPAIGN, N.A.,**

*Respondent.*

---

**On Petition For Writ Of Certiorari  
To The United States Court Of Appeals  
For The Eleventh Circuit**

---

**BRIEF IN OPPOSITION**

---

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**QUESTION PRESENTED**

Whether 11 U.S.C. § 523(a)(4) bars a debtor in bankruptcy from discharging a debt incurred by the debtor while acting as a trustee of an express trust where the debt was incurred by the trustee borrowing from the trust in contravention to the express terms of the trust instrument.

## **CORPORATE DISCLOSURE STATEMENT**

**Respondent BankChampaign, N.A., is a wholly owned subsidiary of Market Place Bancshares. Market Place Bancshares is a privately held entity.**



## TABLE OF CONTENTS

|                                                                                                                                                                                                                                                                                                                                                                                              | Page |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| QUESTION PRESENTED.....                                                                                                                                                                                                                                                                                                                                                                      | i    |
| CORPORATE DISCLOSURE STATEMENT.....                                                                                                                                                                                                                                                                                                                                                          | ii   |
| TABLE OF CONTENTS .....                                                                                                                                                                                                                                                                                                                                                                      | iii  |
| TABLE OF AUTHORITIES .....                                                                                                                                                                                                                                                                                                                                                                   | iv   |
| STATEMENT OF THE CASE.....                                                                                                                                                                                                                                                                                                                                                                   | 1    |
| REASONS FOR DENYING THE PETITION .....                                                                                                                                                                                                                                                                                                                                                       | 2    |
| A. The Court Should Deny The Petition For<br>A Writ Of Certiorari Because The Facts<br>Of This Case, Involving A Trustee's Viola-<br>tion Of An Express Limitation Of The<br>Trust Instrument, Do Not Call For The<br>Court To Address The Divergent Views<br>On The Meaning Of "Defalcation" By A<br>Fiduciary; Under Each Of Those Views, A<br>Trustee Would Have A Strict Liability ..... | 2    |
| B. The Court Should Deny The Petition For<br>A Writ Of Certiorari Because Respondent<br>Does Not Have To Show A Loss In Order<br>For Its Claim To Be Nondischargeable<br>Pursuant To 11 U.S.C. § 523(a)(4).....                                                                                                                                                                              | 6    |
| CONCLUSION.....                                                                                                                                                                                                                                                                                                                                                                              | 7    |

## TABLE OF AUTHORITIES

|                                                                                              | Page       |
|----------------------------------------------------------------------------------------------|------------|
| <b>CASES</b>                                                                                 |            |
| <i>FCC v. NextWave Pers. Commun. Inc.</i> , 537 U.S. 293 (2003).....                         | 6, 7       |
| <i>Johnson v. Home State Bank</i> , 501 U.S. 78 (1991).....                                  | 6          |
| <i>Pennsylvania Dep't of Pub. Welfare v. Davenport</i> , 495 U.S. 552 (1990) .....           | 7          |
| <i>Rutanen ex rel. Quevillon v. Baylis (In re Baylis)</i> , 313 F.3d 9 (1st Cir. 2002) ..... | 3, 4, 5    |
| <i>United States v. Jicarilla Apache Nation</i> , 131 S. Ct. 2313 (2011).....                | 5          |
| <b>STATUTES, RULES AND REGULATIONS</b>                                                       |            |
| 11 U.S.C. § 101(5)(A) .....                                                                  | 6          |
| 11 U.S.C. § 101(12) .....                                                                    | 6          |
| 11 U.S.C. § 523(a) .....                                                                     | 6          |
| 11 U.S.C. § 523(a)(4).....                                                                   | 1, 3, 4, 5 |
| 11 U.S.C. § 524(a)(1).....                                                                   | 6          |
| 11 U.S.C. § 524(a)(2).....                                                                   | 6          |

## STATEMENT OF THE CASE

Respondent contends that where a trustee of an express trust breaches his or her duty of loyalty by violating the express limitations on his or her authority to borrow money from the trust, the trustee's debt arising from such defalcation is excepted from his or her bankruptcy discharge by reason of 11 U.S.C. § 523(a)(4). Under each of the standards for defalcation while acting as a fiduciary articulated by the Circuit Courts under that statute, the debtor-trustee's debt, which arose in this case from his violation of an express limitation on borrowing set forth in the trust instrument, is nondischargeable.

If certiorari were to be granted, Respondent urges that such a strict liability standard would require an affirmance without the need for the Court to pass on the divergent approaches of the Circuit Courts in cases not involving express limitations on a trustee's authority to borrow from the trust. It is further urged by Respondent that a strict liability standard would preclude a reversal. Consequently, if the Court recognizes that a strict liability must be imposed on a trustee who violates an express limitation on his or her authority to borrow from a trust, the present case does not call for a resolution of the divergent tests applied to other types of defalcation by a trustee. Respondent thus urges the Court to deny certiorari as this case does not squarely pose the issue for which Petitioner seeks certiorari.

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## **REASONS FOR DENYING THE PETITION**

- A. The Court Should Deny The Petition For A Writ Of Certiorari Because The Facts Of This Case, Involving A Trustee's Violation Of An Express Limitation Of The Trust Instrument, Do Not Call For The Court To Address The Divergent Views On The Meaning Of "Defalcation" By A Fiduciary; Under Each Of Those Views, A Trustee Would Have A Strict Liability.**

Respondent urges the Court to recognize that under any view of what constitutes a defalcation by a fiduciary, no trustee of an express trust may take action in disregard of express limitations on the authority of the trustee by the terms of the trust instrument and then, when held liable for damages caused by such disregard of a trust instrument's express limitations of authority to discharge such liability in bankruptcy. In that light, the Petition should be denied because if certiorari were granted, this appeal would be decided on the merits for Respondent under each of the standards applied by the various Circuit Courts. Under any standard, without regard to a trustee's good intention, state of mind or honesty of purpose, a trustee cannot discharge through a bankruptcy filing a debt arising from the disregard of a limitation on authority expressly imposed by the trust instrument. Indeed, even under the "extreme reckless" standard advocated by the Petitioner, the Petitioner's debt to Respondent is not dischargeable.

Petitioner relies heavily on *Rutanen ex rel. Quevillon v. Baylis (In re Baylis)*, 313 F.3d 9 (1st Cir. 2002), where the First Circuit articulated an extreme reckless standard for nondischargeability pursuant to section 523(a)(4). However, Petitioner missed the crucial distinction in *Baylis* between a strict test for non-dischargeability for debts incurred by a trustee by reason of self-dealing, and debts resulting from other types of conduct that are governed by less stringent standards. *Baylis* made clear that there is a defalcation within the meaning of section 523(a)(4) if a trustee breaches his or her duty of loyalty. Where, as here, a trustee engages in self-dealing and borrows money from the trust in violation of the trust instrument, the trustee is held “to a very strict standard,” and cannot discharge the resulting debt. As stated in *Baylis*:

In evaluating whether there is a defalcation of a fiduciary duty, there must be reference to the duty involved. Of the various duties, the duty of loyalty is “[t]he most fundamental duty owed . . . the duty of a trustee to administer the trust solely in the interest of the beneficiaries.” 2A A. Scott, *The Law of Trusts* § 170 (W.F. Fratcher ed., 4th ed. 2001).

*Baylis*, 313 F.3d at 20. As further stated in *Baylis*:

Defalcation may be presumed from breach of the duty of loyalty, the duty not to act in the fiduciary’s own interest when that interest



comes or may come into conflict with the beneficiaries' interest.

A trustee occupies a position in which the courts have fixed a very high and very strict standard for his conduct whenever his personal interest comes or may come into conflict with his duty to the beneficiaries.

*Baylis*, 313 F.3d at 20-21 (internal citation omitted). The court there concluded that the debtor's use of trust money for personal attorney fees and to settle a lawsuit brought against him personally was "in violation of his duty of loyalty," and thus, that the debtor-trustee's "actions as to this component of the debt do constitute defalcation." 313 F.3d at 22. In sum, it is clear that where, as here, a trustee borrows money from the trust for personal use in violation of the trust instrument, the trustee's breach of the duty of loyalty constitutes a defalcation which is non-dischargeable as a matter of law under § 523(a)(4).

The Petitioner in the present case unquestionably breached his duty of loyalty by self-dealing. Pet. App. at 57a ("It is undisputed that Defendant lent money to entities in which he had a financial interest or to relatives. Clearly this placed him in a position where he would be tempted to act in his interest, possibly against the interests of the beneficiaries."). As this court has stated with regard to the duty of loyalty and self-dealing,

[a]mong the most fundamental fiduciary obligations of a trustee is "to administer the

trust solely in the interest of the beneficiaries.” 2A A. Scott & W. Fratcher, *Law of Trusts* § 170, p. 311 (4th ed. 1987); see *Meinhard v. Salmon*, 249 N. Y. 458, 464, 164 N. E. 545, 546 (1928) (Cardozo, C. J.) (“Not honesty alone, but the punctilio of an honor the most sensitive,” is “the standard of behavior” for trustees “bound by fiduciary ties”).

*United States v. Jicarilla Apache Nation*, 131 S. Ct. 2313, 2336 (2011). It is this conduct of self-dealing that is characterized as “objectively reckless” by the Eleventh Circuit (see Pet. App. at 11a) and characterized as “extremely reckless” by the Second Circuit. *Baylis*, 313 F.3d at 22. In essence, these courts essentially imposed a strict rule governing non-dischargeability, ruling that self-dealing constitutes a defalcation under section 523(a)(4). Thus, under either standard, the Petitioner’s conduct is not dischargeable pursuant to 11 U.S.C. § 523(a)(4).

This case thus does not present an appropriate opportunity to address the various approaches to the meaning of defalcation taken by the various Circuit Courts because Respondent should prevail under any of the various approaches. A grant of certiorari will not serve to underscore the lesson of this case. A trustee should not be able to discharge a debt that arises from action that exceeds the express limitations on his or her authority by the trust instrument.

**B. The Court Should Deny The Petition For A Writ Of Certiorari Because Respondent Does Not Have To Show A Loss In Order For Its Claim To Be Nondischargeable Pursuant To 11 U.S.C. § 523(a)(4).**

The Petitioner further argues that the Court should grant the Petition because “the Eleventh Circuit here did not require that respondent prove a loss of principal . . . ” Pet. at 10. Petitioner’s contention, however, ignores that Petitioner incurred a debt to Respondent for his own financial benefit that he enjoyed as a result of his defalcation. The Bankruptcy Code does not discharge a “loss,” but rather discharges debts. See 11 U.S.C. § 524(a)(1) (voiding judgments “with respect to any [discharged] *debt*”) (emphasis added); 524(a)(2) (enjoining actions for any “*debt* as a personal liability of the debtor”) (emphasis added). See also 11 U.S.C. § 523(a) (stating that a discharge “does not discharge an individual debtor from any *debt* . . . ”) (emphasis added). The Bankruptcy Code defines a debt as a “liability on a claim.” 11 U.S.C. § 101(12). A “claim” is defined as a “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured.” 11 U.S.C. § 101(5)(A). This Court has stated that “‘claim’ has ‘the broadest available definition’” (*FCC v. NextWave Pers. Communs. Inc.*, 537 U.S. 293, 302 (2003) (citing *Johnson v. Home State Bank*, 501 U.S. 78, 83 (1991))) and that the “plain meaning of a ‘right to payment’ is

nothing more nor less than an enforceable obligation." *FCC v. NextWave*, 537 U.S. at 302 (citing *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. 552, 559 (1990)).

Thus, the debt that the Petitioner seeks to discharge is not limited to a loss of the trust's principal by reason of Petitioner's defalcation, but also all debts that arise from all of Respondent's enforceable claims against the Petitioner, including the disgorgement of the Petitioner's benefit as ordered by the Illinois state court. *See* Pet. App. at 47a. Because Petitioner committed a defalcation while acting as a fiduciary, the Petitioner cannot discharge any liability on Respondent's claim, including the liability for the financial benefit he received as a result of his defalcation.

---

## CONCLUSION

For the foregoing reasons, the Court should deny Petitioner's petition for a writ of certiorari.

Respectfully submitted,

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# **REPLY BRIEF**



SEP 28 2012

CLERK OF THE COURT

IN THE  
**Supreme Court of the United States**

RANDY CURTIS BULLOCK,  
*Petitioner,*

v.

BANKCHAMPAIGN, N.A.,  
*Respondent.*

On Petition for Writ of Certiorari to the  
United States Court of Appeals  
for the Eleventh Circuit

**REPLY BRIEF FOR PETITIONER**

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September 28, 2012

## **TABLE OF CONTENTS**

|                                                                                                     | <b>Page</b> |
|-----------------------------------------------------------------------------------------------------|-------------|
| <b>TABLE OF AUTHORITIES.....</b>                                                                    | <b>ii</b>   |
| <b>THERE WAS NO FINDING OF A VIOLATION OF "AN EXPRESS LIMITATION OF THE TRUST INSTRUMENT" .....</b> | <b>1</b>    |

**TABLE OF AUTHORITIES**

| <b>CASE</b>                                                                                 | <b>Page(s)</b> |
|---------------------------------------------------------------------------------------------|----------------|
| <i>Rutanen ex rel. Quevillon v. Baylis (In re Baylis)</i> , 313 F.3d 9 (1st Cir. 2002)..... | 1              |
| <b>STATUTE</b>                                                                              |                |
| 11 U.S.C. § 523(a)(4).....                                                                  | 1              |

## REPLY BRIEF FOR PETITIONER

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### **There Was No Finding of a Violation of “An Express Limitation of the Trust Instrument.”**

In opposition to the petition, respondent does not dispute or attempt to minimize the longstanding division among the circuits on the standard governing the determination of “defalcation” under § 523(a)(4) of the Bankruptcy Code. Instead, respondent argues that the split among the circuits would not matter to the outcome for petitioner. The stated premise for this argument is that petitioner acted in disregard of “express limitations on the authority of the trustee by the terms of the trust instrument.” Opp. 2. But this premise is incorrect. The Illinois trial court found a factual dispute to exist on whether the loans made by petitioner as trustee were in violation of an express limitation in the trust instrument. Respondent sought summary judgment on that issue, and the motion was denied because the trust instrument was unclear. Pet. App. 53a-54a. The Illinois court found a breach of fiduciary duty under Illinois law, but that finding was not based on a violation of the trust’s express terms. Pet. App. 54a-55a.

Respondent is also incorrect in arguing (Opp. 3) that the First Circuit’s standard, applied in *Rutanen ex rel. Quevillon v. Baylis (In re Baylis)*, 313 F.3d 9 (1st Cir. 2002), would not result in petitioner receiving his discharge. The “extreme recklessness” standard adopted by the First and Second Circuits would almost certainly have resulted in petitioner’s discharge being protected, given the judicial findings by the Illinois state court that he acted with no apparent

ill intent and that there was no loss of trust *res.* The Eleventh Circuit applied a more stringent standard and upheld the exception of the trust-related debt from petitioner's bankruptcy discharge. The Court should take this occasion to lift the fog among the circuits and set the proper standard.

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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# **JOINT APPENDIX**

**In The  
Supreme Court of the United States**

RANDY CURTIS BULLOCK,

*Petitioner,*

v.

BANKCHAMPAIGN, N.A.,

*Respondent.*

**On Writ Of Certiorari To The United States  
Court Of Appeals For The Eleventh Circuit**

**JOINT APPENDIX**

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**Petition For Writ Of Certiorari Filed June 14, 2012  
Petition For Writ Of Certiorari Granted October 29, 2012**

## TABLE OF CONTENTS

|                                                                        | Page |
|------------------------------------------------------------------------|------|
| <i>In re Randy Curtis Bullock</i>                                      |      |
| Case No. 09-84300-JAC7                                                 |      |
| United States Bankruptcy Court for the<br>Northern District of Alabama |      |
| Relevant docket entries .....                                          | 1    |
| <i>BankChampaign, N.A. v. Randy Curtis Bullock</i>                     |      |
| ( <i>In re Bullock</i> )                                               |      |
| Adv. Proc. No. 10-80003-JAC                                            |      |
| United States Bankruptcy Court for the<br>Northern District of Alabama |      |
| Relevant docket entries .....                                          | 3    |
| <i>Randy Curtis Bullock v. BankChampaign, N.A.</i>                     |      |
| ( <i>In re Bullock</i> )                                               |      |
| No. 5:10-cv-01905-IPJ                                                  |      |
| United States District Court for the<br>Northern District of Alabama   |      |
| Relevant docket entries .....                                          | 12   |
| <i>Randy Curtis Bullock v. BankChampaign, N.A.</i>                     |      |
| ( <i>In re Bullock</i> )                                               |      |
| No. 11-11686                                                           |      |
| United States Court of Appeals<br>for the Eleventh Circuit             |      |
| Relevant docket entries .....                                          | 16   |

TABLE OF CONTENTS – Continued

Page

The following opinions, decisions, judgments, and orders have been omitted in printing this joint appendix because they appear on the following pages in the appendix to the Petition for Certiorari:

|                                                                                                                                                                                                                                 |              |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------|
| <i>David S. Bullock v. Randall C. Bullock</i><br>No. 99-CH-34<br>Circuit Court for 5th Judicial Circuit,<br>Vermilion County, Ill.<br>Memorandum and Order (June 11,<br>2002).....                                              | Pet.App. 50a |
| <i>David S. Bullock v. Randall C. Bullock</i><br>No. 99-CH-34<br>Circuit Court for 5th Judicial Circuit,<br>Vermilion County, Ill.<br>Order (Dec. 23, 2002).....                                                                | Pet.App. 45a |
| <i>BankChampaign, N.A. v. Randy Curtis Bullock</i><br>( <i>In re Bullock</i> )<br>Adv. Proc. No. 10-80003-JAC<br>United States Bankruptcy Court for the<br>Northern District of Alabama<br>Memorandum Opinion (May 27, 2010)... | Pet.App. 29a |
| <i>Randy Curtis Bullock v. BankChampaign, N.A.</i><br>( <i>In re Bullock</i> )<br>No. 5:10-cv-01905-IPJ<br>United States District Court for the<br>Northern District of Alabama<br>Memorandum Opinion (Mar. 22, 2011)...        | Pet.App. 16a |

## TABLE OF CONTENTS – Continued

|                                                    | Page         |
|----------------------------------------------------|--------------|
| <i>Randy Curtis Bullock v. BankChampaign, N.A.</i> |              |
| <i>(In re Bullock)</i>                             |              |
| No. 11-11686-DD                                    |              |
| United States Court of Appeals                     |              |
| for the Eleventh Circuit                           |              |
| Order Denying Petition for Rehearing               |              |
| (Mar. 16, 2012) .....                              | Pet.App. 15a |
| <i>Randy Curtis Bullock v. BankChampaign, N.A.</i> |              |
| <i>(In re Bullock)</i>                             |              |
| 670 F.3d 1160 (11th Cir.)                          |              |
| Opinion of Court (Feb. 14, 2012) .....             | Pet.App. 1a  |



*In re Randy Curtis Bullock*  
 United States Bankruptcy Court  
 for the Northern District of Alabama  
 Bankruptcy Case No. 09-84300-JAC7  
 Relevant Docket Entries

| <b>Filing Date</b> | <b>#</b> | <b>Docket Text</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
|--------------------|----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10/21/2009         | <u>1</u> | Chapter 7 Voluntary Petition . Fee Amount \$299 Filed by Randy Curtis Bullock (Attachments: <u>1</u> Property Held for Daughter <u>2</u> Property Held for Wife) (Heard, Kevin) (Entered: 10/21/2009)                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                         |
| 11/19/2009         | 12       | Chapter 7 Trustee's Report of No Distribution: I, Tazewell T Shepard, having been appointed trustee of the estate of the above-named debtor(s), report that I have neither received any property nor paid any money on account of this estate; that I have made a diligent inquiry into the financial affairs of the debtor (s) and the location of the property belonging to the estate; and that there is no property available for distribution from the estate over and above that exempted by law. Unless the Court orders otherwise, I deem abandoned any and all property of the estate that was scheduled in the petition and was unadministered as of the date of this report, and pursuant to Fed R |

Bank 5009, I hereby certify that the estate of the above-named debtor(s) has been fully administered. I request that I be discharged from any further duties as trustee. Key information about this case as reported in schedules filed by the debtor(s) or otherwise found in the case record: This case was pending for 1 month(s). Assets Abandoned: \$ 130535.00, Assets Exempt: \$ 77162.01, Claims Scheduled: \$ 11939718.05, Claims Asserted: Not Applicable, Claims scheduled to be discharged without payment: \$ 11939718.05. (Shepard, Tazewell) (Entered: 11/19/2009)

05/12/2010     18     Order Discharging Debtor  
Signed on 5/12/2010 (RE: related document(s)7 Meeting of Creditors (Chapter 7)). (dwh)  
(Entered: 05/12/2010)

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***BankChampaign, N.A. v. Randy Curtis Bullock***  
***(In re Bullock)***

**United States Bankruptcy Court**  
**for the Northern District of Alabama**  
**Adversary Case No. 10-80003-JAC**  
**Relevant Docket Entries**

| <b>Filing Date</b> | <b>#</b>  | <b>Docket Text</b>                                                                                                                                                                                                                                                                                   |
|--------------------|-----------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 01/11/2010         | <u>1</u>  | Adversary case 10-80003. 67 (Dischargeability – 523(a)(4), fraud as fiduciary, embezzlement, larceny)) Complaint by Bankchampaign, N.A. against Randy Curtis Bullock. Receipt Number O, Fee Amount \$250 (Bensinger, Bill) Modified on 1/11/2010 TO INDICATE FEE IS DUE (dwh). (Entered: 01/11/2010) |
| 02/10/2010         | <u>5</u>  | Answer to Complaint Filed by Randy Curtis Bullock . (kap) (Entered: 02/10/2010)                                                                                                                                                                                                                      |
| 04/21/2010         | <u>11</u> | Motion For Summary Judgment Filed by Plaintiff Bankchampaign, N.A. (Bensinger, Bill) (Entered: 04/21/2010)                                                                                                                                                                                           |
| 04/21/2010         | <u>12</u> | Brief in Support of Motion for Summary Judgment Filed by Plaintiff Bankchampaign, N.A. (RE: related document(s)) <u>11</u> Motion For Summary Judgment Filed by Plaintiff Bankchampaign, N.A. filed                                                                                                  |

by Plaintiff Bankchampaign,  
N.A.). (Bensinger, Bill)  
(Entered: 04/21/2010)

- |            |           |                                                                                                                                                                                                                                                                                                                                                                                                     |
|------------|-----------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 04/21/2010 | <u>14</u> | <p><i>Brief in Support of Motion for Summary Judgment</i> Filed by Plaintiff Bankchampaign, N.A. (RE: related document(s)<u>11</u> Motion For Summary Judgment Filed by Plaintiff Bankchampaign, N.A. filed by Plaintiff Bankchampaign, N.A.). (Attachments: <u>1</u> Exhibit A<u>2</u> Exhibit B<u>3</u> Exhibit C<u>4</u> Exhibit D<u>5</u> Exhibit E)(Bensinger, Bill) (Entered: 04/21/2010)</p> |
| 04/29/2010 | <u>17</u> | <p>Answer (related document(s); <u>11</u> Motion For Summary Judgment filed by Plaintiff Bankchampaign, N.A.) Filed by Defendant Randy Curtis Bullock (kap) (Entered: 04/29/2010)</p>                                                                                                                                                                                                               |
| 04/29/2010 | <u>18</u> | <p>Brief in Opposition to Plaintiff's Motion for Summary Judgment Filed by Defendant Randy Curtis Bullock (RE: related document(s)<u>11</u> Motion For Summary Judgment Filed by Plaintiff Bankchampaign, N.A. filed by Plaintiff Bankchampaign, N.A.). (Attachments: <u>1</u> Exhibit <u>12</u> Exhibit <u>23</u> Exhibit <u>34</u> Exhibit</p>                                                    |

45 Exhibit 56 Exhibit 67  
 Exhibit 78 Exhibit 8, 9, 109  
 Exhibit 1110 Exhibit 1211  
 Exhibit 1312 Exhibit 1413  
 Exhibit 1514 Exhibit 1615  
 Exhibit 1816 Exhibit 1917  
 Exhibit 2018 Exhibit 2119  
 Exhibit 21 – Continued20  
 Exhibit 2221 Exhibit 22  
 continued22 Exhibit 2323  
 Exhibit 23 continued24 Ex-  
 hibit 2425 Exhibit 2526  
 Exhibit 2627 Exhibit 2728  
 Exhibit 2829 Exhibit 2930  
 Exhibit 3031 Exhibit 3132  
 Exhibit 3233 Exhibit 3334  
 Exhibit 34, 35, 3635 Exhibit  
3736 Exhibit 38(kap)  
 (Entered: 04/29/2010)

04/29/2010      19      Hearing Scheduled (RE:  
 related document(s)17  
 Answer filed by Defendant  
 Randy Curtis Bullock)  
 Hearing scheduled 5/5/2010  
 at 09:00 AM at 3rd Floor  
 Courtroom Decatur. (kap)  
 (Entered: 04/29/2010)

05/03/2010      20      Reply to (Re Item: 11, 17)  
*Debtor's Answer to Motion*  
*for Summary Judgment* Filed  
 by Plaintiff Bankchampaign,  
 N.A. (Bensinger, Bill) (En-  
 tered: 05/03/2010)



|            |           |                                                                                                                                                                                                                         |
|------------|-----------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 05/05/2010 | <u>22</u> | Exhibit and Witness List<br>Filed by Defendant Randy<br>Curtis Bullock . (Attach-<br>ments: <u>1</u> Exhibit List)(kap)<br>(Entered: 05/05/2010)                                                                        |
| 05/05/2010 | <u>24</u> | Reply to Bankchampaign's<br>Reply (Re Item: <u>20</u> ) Filed<br>by Defendant Randy<br>Curtis Bullock (kap)<br>(Entered: 05/06/2010)                                                                                    |
| 05/17/2010 | <u>26</u> | Brief Filed by Defendant<br>Randy Curtis Bullock . (kap)<br>(Entered: 05/17/2010)                                                                                                                                       |
| 05/20/2010 | <u>27</u> | Second Brief Regarding<br>Elements Necessary to Prove<br>Fraud in Illinois Filed by<br>Defendant Randy Curtis<br>Bullock . (Attachments: <u>1</u><br>Exhibit <u>12</u> Exhibit <u>2</u> )(kap)<br>(Entered: 05/20/2010) |
| 05/27/2010 | <u>28</u> | Memorandum Opinion Signed<br>on 5/27/2010 (RE: related<br>document(s)) <u>11</u> Motion for<br>Summary Judgment filed by<br>Plaintiff Bankchampaign, N.A.).<br>(kap) (Entered: 05/27/2010)                              |
| 05/27/2010 | <u>29</u> | Judgment in Favor of<br>BankChampaign in the<br>Amount of \$250,000 plus<br>attorneys fees and costs of<br>\$35,000 Signed on 5/27/2010.<br>(kap) (Entered: 05/27/2010)                                                 |

|            |           |                                                                                                                                                                                                                                                                                                                            |
|------------|-----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 06/03/2010 | <u>32</u> | Notice of Appeal to District Court. Filed by Defendant Randy Curtis Bullock (RE: related document(s) <u>28</u> Memorandum Opinion, <u>29</u> Judgment). Appellant Designation due by 6/17/2010. (kap) (Entered: 06/03/2010)                                                                                                |
| 06/03/2010 | <u>33</u> | Service of Notice of Appeal by Court (RE: related document(s) <u>32</u> Notice of Appeal). (kap) (Entered: 06/03/2010)                                                                                                                                                                                                     |
| 06/10/2010 | <u>37</u> | Statement of Issues on Appeal, (Re Item: <u>32</u> ) Filed by Defendant Randy Curtis Bullock (RE: related document(s) <u>32</u> Notice of Appeal). (bnh) (Entered: 06/10/2010)                                                                                                                                             |
| 06/10/2010 | <u>38</u> | Appellant Designation of Contents For Inclusion in Record On Appeal Filed by Defendant Randy Curtis Bullock (RE: related document(s) <u>32</u> Notice of Appeal). Appellee designation due by 6/24/2010. Transmission of Designation Due by 7/12/2010. Appellant Designation due by 6/24/2010. (bnh) (Entered: 06/10/2010) |
| 06/16/2010 | <u>39</u> | Transcript of hearing held on: 5/15/10 You are noticed that a transcript has been filed.                                                                                                                                                                                                                                   |

Pursuant to the Judicial Conference Policy on Privacy, remote electronic access to this transcript is restricted through 09/14/2010. To review the transcript for redaction purposes, you may purchase a copy from the transcriber, or the transcript may be viewed at the public terminal located in the Bankruptcy Court Clerk's Office. Contact the Court Reporter/Transcriber Patricia Basham, telephone number 901-372-0613/triciabasham@bellsouth.net. All parties have seven (7) calendar days to file a Notice of Intent to Request Transcript Redaction of any social security numbers, financial account data, names of minor-age children, dates of birth, and home addresses. If the Notice of Intent is filed, the party has 21 calendar days from the date the transcript was filed to file the Transcript Redaction Request indicating the location of the identifiers within the transcript with the Court and to provide the list to the transcriber. The redacted transcript is due 31 days from the date of filing of the transcript. The transcript will be made

electronically available to the general public 90 calendar days from the date of filing. Notice of Intent to Request Redaction Deadline Due By 6/23/2010. Redaction Request Due By 07/7/2010. Redacted Transcript Submission Due By 07/19/2010. Transcript access will be restricted through 09/14/2010. (Basham, Patricia) (Entered: 06/16/2010)

- |            |           |                                                                                                                                                                                                                                 |
|------------|-----------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 07/12/2010 | <u>42</u> | Certificate of Record on Appeal (Re Item: <u>32</u> Notice of Appeal filed by Defendant Randy Curtis Bullock) (Entered: 07/12/2010)                                                                                             |
| 07/14/2010 | <u>43</u> | Certificate of Record on Appeal: #CV-10-J-1905-NE (Re Item: <u>32</u> Notice of Appeal filed by Defendant Randy Curtis Bullock) Filed by (RE: related document(s) <u>32</u> Notice of Appeal). (thc) (Entered: 07/14/2010)      |
| 01/26/2011 | <u>44</u> | Order from District Court Judge Inge Prytz Johnson Administratively Closing Appeal Subject to Reopening Should the Same be Necessary Signed on 1/26/2011 (RE: related document(s) <u>32</u> Notice of Appeal filed by Defendant |

Randy Curtis Bullock). (kap)  
(Entered: 01/28/2011)

02/28/2011 Adversary Case 8:10-ap-80003  
Closed (kap) (Entered:  
02/28/2011)

03/22/2011 45 Memorandum Opinion Signed  
by U.S. District Judge Inge Prytz  
Johnson on 3/22/2011 (RE:  
related document(s)32 Notice  
of Appeal filed by Defendant  
Randy Curtis Bullock). (kap)  
(Entered: 04/11/2011)

03/22/2011 46 Final Order By District Court  
Judge Inge Prytz Johnson, Re:  
Appeal on Civil Action Number:  
CV-10-J-1905-NE, Affirming  
Signed on 3/22/2011 (RE:  
related document(s)45  
Memorandum Opinion). (kap)  
(Entered: 04/11/2011)

04/14/2011 47 UNITED STATES COURT  
OF APPEALS FOR THE  
ELEVENTH CIRCUIT CASE  
NUMBER 11-11686DD (RE:  
related document(s)46 Order  
District Court re: Appeal).  
(kap) (Entered: 12/05/2011)

04/09/2012 48 USCA JUDGMENT as to  
Notice of Appeal from District  
Court filed by Randy Curtis  
Bullock; the decision of  
the bankruptcy court is



**AFFIRMED, issued as mandate  
4/6/12. (Attachments: # 1  
Published Opinion) (mmb)  
(Entered: 10/11/2012)**

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*Randy Curtis Bullock v.*  
*BankChampaign, N.A. (In re Bullock)*  
 United States District Court  
 for the Northern District of Alabama  
 Case No. 5:10-cv-01905-IPJ  
 Relevant Docket Entries

| <b>Date Filed</b> | <b>#</b> | <b>Docket Text</b>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
|-------------------|----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 07/14/2010        | <u>1</u> | Notice of APPEAL FROM BANKRUPTCY COURT. Bankruptcy Court case number 09-84300-JAC-7. File received, filed by Randy Curtis Bullock. (Bankruptcy Record in PDF on CD in file) (Attachments: # <u>1</u> Certificate of Record on Appeal) (ASL) (Additional attachment(s) added on 8/5/2011: # <u>2</u> Transcript of Proceedings, # <u>3</u> 1A – Memorandum Opinion, # <u>4</u> 1B – Judgment, # <u>5</u> 2 – Notice of Appeal, # <u>6</u> 3 – Service of Notice of Appeal by Court, # <u>7</u> 4 – Notice of Parties Regarding Designations, # <u>8</u> 5 – Appellant Designation, # <u>9</u> 6 – Appellant Statement of Issues, # <u>10</u> 1 – Complaint, # <u>11</u> 3 – Summons and Notice of Pretrial Conference, # <u>12</u> 4 – BNC Certificate of Service, # <u>13</u> 5 – Answer, # <u>14</u> 6 – Hearing Scheduled, # <u>15</u> 9 – Pretrial Order, # <u>16</u> 10 – BNC Certificate of Mailing, # <u>17</u> 11 – Motion for Summary Judgment by pla, # <u>18</u> 12 – Brief in support of Motion for |

Summary Judgment, # 19 corrective entry, # 20 14 – Brief in support of MSJ with exhibits, # 21 15 – Notice of Hearing, # 22 16 – BNC Certificate of Mailing, # 23 17 – Answer, # 24 18 – part 1 – Brief in opp to pla's MSJ, # 25 18 – part 2 – Brief in opp to pla's MSJ, # 26 18 – part 3 – Brief in opp to pla's MSJ, # 27 18 – part 4 – Brief in opp to pla's MSJ, # 28 18 – part 5 – Brief in opp to pla's MSJ, # 29 18 – part 6 – Brief in opp to pla's MSJ, # 30 18 – part 7 – Brief in opp to pla's MSJ, # 31 18 – part 8 – Brief in opp to pla's MSJ, # 32 19 – Hearing Scheduled, # 33 20 – Reply by Bank Champaign, # 34 21 – Hearing Scheduled, # 35 22 – Exhibit and Witness List, # 36 24 – Reply, # 37 26 – Brief filed by dft, # 38 27 – Second Brief filed by dft, # 39 28 – Memorandum Opinion, # 40 29 – Judgment) (ASL,). Modified on 8/5/2011 – BK Record added from CD originally submitted 7/14/10 (ASL,). (Entered: 07/16/2010)

07/26/2010      3    Appellant's BRIEF by Randy Curtis Bullock. Appellee Brief due by 8/10/2010. (Engelthaler, James) (Entered: 07/26/2010)

- 08/10/2010     4     Appellee's BRIEF by BankChampaign NA. Appellant Reply Brief due by 8/24/2010. (Bensinger, Bill) (Entered: 08/10/2010)
- 08/23/2010     5     Appellant's REPLY BRIEF by Randy Curtis Bullock. (Engelthaler, James) (Entered: 08/23/2010)
- 03/22/2011     12     MEMORANDUM OPINION. Signed by Judge Inge P Johnson on 3/22/11. (ASL) (Entered: 03/22/2011)
- 03/22/2011     13     ORDER in accordance with memorandum opinion, the Order of the Bankruptcy Court is AFFIRMED. Signed by Judge Inge P Johnson on 3/22/11. (ASL) (Entered: 03/22/2011)
- 03/30/2011     14     NOTICE OF APPEAL by Randy Curtis Bullock. Filing fee \$ 455, receipt number 1126-1368113. Appeal Record due by 4/13/2011. (Engelthaler, James) Modified on 3/31/2011 – NDAL receipt #B4601021544 (ASL). (Entered: 03/30/2011)
- 04/11/2011     15     DESIGNATION of Record on Appeal by Randy Curtis Bullock re 14 Notice of Appeal (Engelthaler, James) (Entered: 04/11/2011)

04/12/2011      Transmission of Notice of Appeal and Docket Sheet to US Court of Appeals re 14 Notice of Appeal (KGE) (Entered: 04/12/2011)

04/22/201      16      USCA Case Number 11-11686DD for 14 Notice of Appeal filed by Randy Curtis Bullock. (ASL) (Entered: 04/22/2011)

08/05/2011      Pursuant to F.R.A.P. 11(c), the Clerk of the District Court for the Northern District of Alabama certifies that the record is complete for purposes of this appeal re: 14 Notice of Appeal, Appeal No. 11-11686DD. The entire record on appeal is available electronically (ASL) (Entered: 08/05/2011)

04/09/2012      17      USCA JUDGMENT as to 14 Notice of Appeal filed by Randy Curtis Bullock; the decision of the bankruptcy court is AFFIRMED, issued as mandate 4/6/12 (Attachments: # 1 Published Opinion) (ASL) (Entered: 04/09/2012)

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***Randy Curtis Bullock v.  
BankChampaign, N.A. (In re Bullock)***  
**United States Court of Appeals  
for the Eleventh Circuit  
Case No. 11-11686  
Relevant Docket Entries**

- 04/14/2011    CIVIL APPEAL DOCKETED. Notice of appeal filed by Appellant Randy Curtis Bullock on 04/14/2011. Appellant brief due 40 days from 04/14/2011. Fee Status: Fee Paid.**
- 04/25/2011    APPEARANCE of Counsel filed by Attorney Bill D. Bensinger for Appellee BankChampaign NA in 11-11686.**
- 04/26/2011    APPEARANCE of Counsel filed by James R. Engelthaler for Randy Curtis Bullock.**
- 05/11/2011    Appellant's brief filed by Randy Curtis Bullock. Deficiencies: no e-brief. Service date: 05/11/2011 [11-11686] Attorney for Appellee: Bensinger – US mail.**
- 05/16/2011    E-Brief Tendered: Appellant brief for Appellant Randy Curtis Bullock.**
- 05/16/2011    Brief modifications received on 05/16/2011 (brief upload) from Appellant Randy Curtis Bullock. All deficiencies have been corrected.**
- 07/28/2011    E-Brief Tendered: Appellee brief for Appellee BankChampaign NA.**
- 07/29/2011    Appellee's Brief filed by Appellee BankChampaign NA. Service date:**

- 07/28/2011 US mail – Attorney for Appellant: Engelthaler.
- 08/10/2011 E-Brief Tendered: Reply brief for Appellant Randy Curtis Bullock.
- 08/12/2011 Reply Brief filed by Appellant Randy Curtis Bullock. Deficiencies: No Table of Record References. Service 08/10/2011 US mail – Attorney for Appellee: Bensinger.
- 08/24/2011 E-Brief Tendered: Reply brief for Appellant Randy Curtis Bullock.
- 09/14/2011 Appellant Randy Curtis Bullock has been notified by letter that the reply brief corrections (TRR) are overdue and a motion for leave to file them out of time is due within 14 days from this notice.
- 09/14/2011 Public Communication: Corrections to the appellant's reply brief have been made. The brief is now in compliance.
- 11/04/2011 Oral argument scheduled. Argument Date: Friday, 12/02/2011 Argument Location: Atlanta Courtroom: Atlanta 339.
- 11/08/2011 Additional copies of expanded record excerpts received from James R. Engelthaler for Randy Curtis Bullock and forwarded to the record room.
- 11/16/2011 MOTION to not participate in oral argument. filed by Appellee BankChampaign NA. Opposition to Motion is Unknown [6428915-1]

- 11/17/2011 **RESPONSE to Motion to not appear in oral argument and Motion to strike filed by Appellee BankChampaign NA in 11-11686 filed by Attorney James R. Engelthaler for Appellant Randy Curtis Bullock.**
- 11/21/2011 **ORDER: Motion to not appear in oral argument filed by Appellee BankChampaign NA is DENIED [6428915-2] ENTERED FOR THE COURT BY DIRECTION**
- 11/30/2011 **ORDER: The Court has reconsidered Appellee's Motion to not participate in oral argument scheduled for Friday, December 2, 2011 and the Motion is hereby GRANTED. [6428915-2] RB**
- 12/02/2011 **Oral argument held. Oral Argument participants were Attorney James R. Engelthaler for Appellant Randy Curtis Bullock.**
- 02/14/2012 **Opinion issued by court as to Appellant Randy Curtis Bullock. Decision: Affirmed. Opinion type: Published. Opinion method: Signed. – [Edited 03/05/2012 by EM]**
- 02/14/2012 **Judgment entered as to Appellant Randy Curtis Bullock.**
- 03/02/2012 **Petition for panel rehearing filed by Appellant Randy Curtis Bullock.**
- 03/16/2012 **ORDER: Petition for panel rehearing filed by Appellant Randy Curtis Bullock is DENIED. [6518432-1]**

- 03/23/2012    **MOTION to stay mandate filed by Appellant Randy Curtis Bullock. Opposition to Motion is Unknown [6527662-1]**
- 03/30/2012    **ORDER: Motion to stay mandate filed by Appellant Randy Curtis Bullock is DENIED [6527662-2] RB**
- 04/06/2012    **Mandate issued as to Appellant Randy Curtis Bullock.**
- 06/20/2012    **Notice of Writ of Certiorari filed as to Appellant Randy Curtis Bullock. SC# 11-1518.**
- 11/08/2012    **Writ of Certiorari filed as to Appellant Randy Curtis Bullock is GRANTED. SC# 11-1518.**
-

# **PETITIONER'S BRIEF**

DEC 13 2012

OFFICE OF THE CLERK

**In The  
Supreme Court of the United States**

**RANDY CURTIS BULLOCK,**

*Petitioner,*

**v.**

**BANKCHAMPAIGN, N.A.,**

*Respondent.*

**On Writ Of Certiorari To The United States  
Court Of Appeals For The Eleventh Circuit**

**BRIEF FOR PETITIONER**

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**December 13, 2012**



## QUESTIONS PRESENTED

What degree of misconduct by a trustee constitutes "defalcation" under § 523(a)(4) of the Bankruptcy Code that disqualifies the errant trustee's resulting debt from a bankruptcy discharge—and does it include actions that resulted in no loss of trust property?

# TABLE OF CONTENTS

|                                                                                                                                                            | Page |
|------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| QUESTIONS PRESENTED .....                                                                                                                                  | i    |
| TABLE OF CONTENTS.....                                                                                                                                     | ii   |
| TABLE OF AUTHORITIES .....                                                                                                                                 | iv   |
| OPINIONS BELOW .....                                                                                                                                       | 1    |
| JURISDICTION .....                                                                                                                                         | 1    |
| STATUTORY PROVISION INVOLVED.....                                                                                                                          | 1    |
| STATEMENT OF THE CASE.....                                                                                                                                 | 1    |
| SUMMARY OF ARGUMENT .....                                                                                                                                  | 6    |
| ARGUMENT.....                                                                                                                                              | 9    |
| I. Exceptions of Debts from Discharge Are<br>Construed to Safeguard the “Fresh Start”<br>That Is the Primary Objective of Individ-<br>ual Bankruptcy ..... | 9    |
| II. The Court Has Repeatedly Resisted Expan-<br>sion of the Defalcation Exception, but Has<br>Not Addressed the Question Presented .....                   | 11   |
| 1. Conscious Misbehavior or Extreme<br>Recklessness .....                                                                                                  | 16   |
| 2. Knowing Breach or Objective<br>Recklessness .....                                                                                                       | 18   |
| 3. Negligent or Innocent Mistake .....                                                                                                                     | 19   |
| 4. The Requirement of Failure to Account...                                                                                                                | 20   |
| III. Conscious Misbehavior or Extreme Reck-<br>lessness Should Be Required to Except Fi-<br>duciary Debts from Discharge—and Is<br>Absent Here .....       | 21   |

## TABLE OF CONTENTS – Continued

|                                                                                                                               | Page |
|-------------------------------------------------------------------------------------------------------------------------------|------|
| IV. Failure to Account for Entrusted Property<br>Is an Essential Element of "Defalcation"—<br>and Is Absent Here As Well..... | 26   |
| CONCLUSION .....                                                                                                              | 28   |

## TABLE OF AUTHORITIES

|                                                                                                        | Page          |
|--------------------------------------------------------------------------------------------------------|---------------|
| <b>CASES</b>                                                                                           |               |
| <i>Angelle v. Reed (In re Angelle)</i> , 610 F.2d 1335<br>(5th Cir. 1980) .....                        | 24            |
| <i>Beecham v. United States</i> , 511 U.S. 368 (1994).....                                             | 7, 22         |
| <i>Blyler v. Hemmeter (In re Hemmeter)</i> , 242 F.3d<br>1186 (9th Cir. 2001).....                     | 20, 26–27     |
| <i>Brown v. Felsen</i> , 442 U.S. 127 (1979) .....                                                     | 8, 26         |
| <i>Bullock v. BankChampaign, N.A. (In re Bullock)</i> ,<br>670 F.3d 1160 (11th Cir. 2012).....         | 1, 18         |
| <i>Central Hanover Bank &amp; Trust Co. v. Herbst</i> ,<br>93 F.2d 510 (2d Cir. 1937).....             | 14, 27        |
| <i>Chapman v. Forsyth</i> , 43 U.S. (2 How.) 202<br>(1844).....                                        | 11            |
| <i>Commonwealth Land Title Co. v. Blaszak (In re<br/>Blaszak)</i> , 397 F.3d 386 (6th Cir. 2005) ..... | 20            |
| <i>Crawford v. Burke</i> , 195 U.S. 176 (1904).....                                                    | 13            |
| <i>Cundy v. Woods (In re Woods)</i> , 284 B.R. 282 (D.<br>Colo. 2001).....                             | 27            |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328<br>(1934).....                                     | 13–14         |
| <i>Denton v. Hyman (In re Hyman)</i> , 502 F.3d 61<br>(2d Cir. 2007).....                              | 16–17, 23, 26 |
| <i>Dura Pharm., Inc. v. Broudo</i> , 544 U.S. 336<br>(2005).....                                       | 23            |
| <i>Ernst &amp; Ernst v. Hochfelder</i> , 425 U.S. 185<br>(1976).....                                   | 16, 18, 23    |

## TABLE OF AUTHORITIES – Continued

|                                                                                                     | Page      |
|-----------------------------------------------------------------------------------------------------|-----------|
| <i>Field v. Mans</i> , 516 U.S. 59 (1995).....                                                      | 23–24     |
| <i>FNFS, Ltd. v. Harwood (In re Harwood)</i> , 637<br>F.3d 615 (5th Cir. 2011).....                 | 18–19     |
| <i>Follett Higher Educ. Grp. v. Berman (In re<br/>Berman)</i> , 629 F.3d 761 (7th Cir. 2011) .....  | 19        |
| <i>Freeman v. Quicken Loans, Inc.</i> , ___ U.S. ___,<br>132 S. Ct. 2034 (2012).....                | 21        |
| <i>Gleason v. Thaw</i> , 236 U.S. 558 (1915).....                                                   | 9, 11     |
| <i>Greebel v. FTP Software, Inc.</i> , 194 F.3d 185 (1st<br>Cir. 1999).....                         | 16        |
| <i>Grogan v. Garner</i> , 498 U.S. 279 (1991).....                                                  | 9         |
| <i>Guerra v. Fernandez-Rocha (In re Fernandez-<br/>Rocha)</i> , 451 F.3d 813 (11th Cir. 2006) ..... | 26        |
| <i>Hennequin v. Clews</i> , 111 U.S. 676 (1884) .....                                               | 13        |
| <i>Jarecki v. G. D. Searle &amp; Co.</i> , 367 U.S. 303<br>(1961).....                              | 23        |
| <i>Kawaauhau v. Geiger</i> , 523 U.S. 57 (1998).....                                                | 9, 10, 11 |
| <i>Lewis v. Scott (In re Lewis)</i> , 97 F.3d 1182 (9th<br>Cir. 1996).....                          | 20        |
| <i>Local Loan Co. v. Hunt</i> , 292 U.S. 234 (1934) .....                                           | 9         |
| <i>McClellan v. Cantrell</i> , 217 F.3d 890 (7th Cir.<br>2000).....                                 | 22        |
| <i>Meyer v. Rigdon</i> , 36 F.3d 1375 (7th Cir. 1994) .....                                         | 19        |
| <i>Moore v. United States</i> , 160 U.S. 268 (1895) .....                                           | 22        |

## TABLE OF AUTHORITIES – Continued

|                                                                                                           | Page              |
|-----------------------------------------------------------------------------------------------------------|-------------------|
| <i>Moreno v. Ashworth (In re Moreno)</i> , 892 F.2d<br>417 (5th Cir. 1990) .....                          | 19                |
| <i>Neal v. Clark</i> , 95 U.S. 704 (1877).....                                                            | 12, 21–22         |
| <i>Office of Thrift Supervision v. Felt (In re Felt)</i> ,<br>255 F.3d 220 (5th Cir. 2001) .....          | 19                |
| <i>Ormsby v. First Am. Title Co. (In re Ormsby)</i> ,<br>591 F.3d 1199 (9th Cir. 2010).....               | 22                |
| <i>Otto v. Niles (In re Niles)</i> , 106 F.3d 1456 (9th<br>Cir. 1997) .....                               | 15                |
| <i>Pahlavi v. Ansari (In re Ansari)</i> , 113 F.3d 17<br>(4th Cir. 1997) .....                            | 19                |
| <i>Palmacci v. Umpierrez</i> , 121 F.3d 781 (1st Cir.<br>1997).....                                       | 26                |
| <i>Patel v. Shamrock Floorcovering Servs., Inc. (In<br/>re Patel)</i> , 565 F.3d 963 (6th Cir. 2009)..... | 19                |
| <i>Quaif v. Johnson</i> , 4 F.3d 950 (11th Cir. 1993) .....                                               | 26                |
| <i>R.E. Am., Inc. v. Garver (In re Garver)</i> , 116<br>F.3d 176 (6th Cir. 1997) .....                    | 15, 20            |
| <i>Republic of Rwanda v. Uwimana (In re<br/>Uwimana)</i> , 274 F.3d 806 (4th Cir. 2001).....              | 19, 20            |
| <i>Rizek v. SEC</i> , 215 F.3d 157 (1st Cir. 2000) .....                                                  | 18                |
| <i>Rutanen ex rel. Quevillon v. Baylis (In re<br/>Baylis)</i> , 313 F.3d 9 (1st Cir. 2002) ...            | 15, 16, 17–18, 23 |
| <i>Schwager v. Fallas (In re Schwager)</i> , 121 F.3d<br>177 (5th Cir. 1997) .....                        | 19                |



## TABLE OF AUTHORITIES – Continued

|                                                                                                     | Page |
|-----------------------------------------------------------------------------------------------------|------|
| <i>Sherman v. Potapov (In re Sherman)</i> , 603 F.3d<br>11 (1st Cir. 2010) .....                    | 22   |
| <i>Sherman v. SEC (In re Sherman)</i> , 658 F.3d<br>1009 (9th Cir. 2011) .....                      | 20   |
| <i>Tudor Oaks Ltd. P'ship v. Cochrane (In re<br/>Cochrane)</i> , 124 F.3d 978 (8th Cir. 1997) ..... | 20   |
| <i>United States v. Williams</i> , 553 U.S. 285 (2008) .....                                        | 21   |
| <i>Upshur v. Briscoe</i> , 138 U.S. 365 (1891) .....                                                | 12   |
| <i>Williams v. U.S. Fid. &amp; Guar. Co.</i> , 236 U.S. 549<br>(1915) .....                         | 9    |

## STATUTES AND REGULATIONS

|                                                                           |               |
|---------------------------------------------------------------------------|---------------|
| 11 U.S.C. § 523 .....                                                     | 11            |
| 11 U.S.C. § 523(a) .....                                                  | 1, 9          |
| 11 U.S.C. § 523(a)(2) .....                                               | 10, 15, 24    |
| 11 U.S.C. § 523(a)(4) .....                                               | <i>passim</i> |
| 11 U.S.C. § 523(a)(6) .....                                               | 10            |
| 11 U.S.C. § 523(a)(9) .....                                               | 10            |
| 11 U.S.C. § 523(a)(11) .....                                              | 10            |
| 28 U.S.C. § 1254(1) .....                                                 | 1             |
| Act of Aug. 19, 1841, ch. 9, 5 Stat. 441<br>(repealed 1843) .....         | 8, 11, 27     |
| Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533<br>(repealed 1878) ..... | 12, 13        |

## TABLE OF AUTHORITIES – Continued

|                                                                                                                              | Page      |
|------------------------------------------------------------------------------------------------------------------------------|-----------|
| Act of July 1, 1898, ch. 541, § 17(4), 30 Stat.<br>550–51 (repealed 1979).....                                               | 13, 27    |
| Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat.<br>2549 .....                                                              | 8, 14, 27 |
| <br>OTHER AUTHORITIES                                                                                                        |           |
| BLACK'S LAW DICTIONARY 479 (9th ed. 2009) .....                                                                              | 21        |
| 4 COLLIER ON BANKRUPTCY ¶ 523.05 (16th ed.<br>2012) .....                                                                    | 9         |
| SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH<br>LANGUAGE 6L (1755).....                                                       | 27        |
| REP. OF THE COMM'N ON THE BANKRUPTCY LAWS<br>OF THE UNITED STATES, H.R. DOC. NO. 93-137<br>(1973).....                       | 14–15     |
| RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(3)<br>(2007).....                                                                  | 25        |
| ANTONIN SCALIA & BRYAN A. GARNER, READING<br>LAW: THE INTERPRETATION OF LEGAL TEXTS<br>§ 31 (2012) .....                     | 21        |
| Charles Jordan Tabb, <i>The Historical Evolution<br/>of the Bankruptcy Discharge</i> , 65 AM. BANKR.<br>L.J. 325 (1991)..... | 10        |
| NOAH WEBSTER, AN AMERICAN DICTIONARY OF<br>THE ENGLISH LANGUAGE 56 (1828).....                                               | 27        |

## **OPINIONS BELOW**

The opinion of the court of appeals is reported at 670 F.3d 1160 (11th Cir. 2012). Pet. App. 1a–14a. The respective memorandum opinions of the district and bankruptcy courts for the Northern District of Alabama are unreported. Pet. App. 16a–28a, 29a–44a.

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## **JURISDICTION**

The judgment of the court of appeals was entered on February 14, 2012. The court denied rehearing on March 16, 2012. Pet. App. 15a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

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## **STATUTORY PROVISION INVOLVED**

Section 523 of the United States Bankruptcy Code provides: “(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt . . . (4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny . . . .”

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## **STATEMENT OF THE CASE**

1. This case began as a dispute among family members over administration of the father’s life insurance trust and ultimately resulted in the Chapter 7 bankruptcy of one of the children, petitioner Randy

Curtis Bullock, who had been appointed by his father as trustee. Petitioner's father, Curt Bullock, created the trust, the Curt Bullock Trust No. 2, in 1978. The trust's sole asset was the father's life insurance policy, which featured a \$1 million death benefit and accumulated cash value. Petitioner and his siblings were named as beneficiaries. Until his father approached him about a loan from the trust, petitioner did not know that he was the trustee. In fact, neither he nor any of his four siblings was aware that the trust existed. Pet. App. 45a.

2. The dispute involved three loans taken against the cash value of the life insurance policy. All three loans were repaid in full, with six percent interest. Pet. App. 17a, 45a, 50a. The first loan, for \$117,545.96, was made in 1981 at the request of petitioner's father, the settlor of the trust. The loan went to petitioner's mother, Imogene Bullock, so that she could repay a debt that she owed to the family garage-construction business. Pet. App. 2a; RE, Vol. 1, Tab M, Exs. 1 & 2.<sup>1</sup> The second loan, for \$80,257.04, was made in 1984 to petitioner and his mother. The loan proceeds were used to purchase certificates of deposit, which later were cashed and used, along with other funds, to purchase a garage-fabrication mill in Springfield, Ohio, for approximately \$200,000.00. Pet. App. 2a. The third loan, for \$66,223.96, was made in 1990 to

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<sup>1</sup> The abbreviation "RE" refers to record excerpts filed in the Eleventh Circuit.

petitioner and his mother and used in the purchase of an office building and other Springfield real estate. Pet. App. 2a. The loans, totaling \$264,026.96, were secured by first mortgages on property appraised for approximately \$477,000.00. RE, Vol. 1, Tab M, Exs. 8 & 9. Payments were made on the loans for 13 years. RE, Vol. 2, Ex. 18. Relying on the insurance agent who sold his father the policy and advised him on creation of the trust, petitioner did not believe the loans were improper and regarded them as safe investments of the cash value. RE, Vol. 1, Tab M at 13-14. The trust instrument itself did not expressly prohibit transactions with family members or with the trustee.

3. Petitioner resigned as the trustee for the trust in 1998 at the request of some of the beneficiaries. *Id.* at 2. Respondent, BankChampaign, N.A., was designated successor trustee. Within a few months after resigning, petitioner paid the remaining balance of the loans, with interest. *Id.* The payments made on the loans by petitioner and his mother totaled \$455,440.76. *Id.* The trust's sole asset, the life insurance policy, had the same value it had when the trust was created. RE, Vol. 2, Ex. 18.

4. In 1999, two of the five beneficiaries of the trust, petitioner's two brothers, filed an action in the Circuit Court of Vermilion County, Illinois, asserting claims that petitioner breached his fiduciary duty as trustee of the Curt Bullock Trust. Petitioner's brothers claimed that any profits earned by petitioner and his mother as a result of the loans should be

turned over to the trust. The action also named as defendants other businesses in which petitioner had an interest and sought a constructive trust on all profits, proceeds, and assets obtained by petitioner and the other defendants. Pet. App. 47a.

5. In 2002, the Illinois court found that petitioner did "not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a. The court also found that petitioner "has shown his willingness to make the Trust whole by a pattern of payments he has made to repay the loans from the Trust." *Id.* The court made no other finding concerning petitioner's intent, knowledge, purpose, or state of mind. The court found that the trust did not earn any profit on the loans, which were repaid at the same interest rate charged by the insurance company for the loans of the policy's cash value. But the court granted summary judgment in favor of petitioner's brothers because the fully repaid loans were deemed self-dealing transactions and thus breaches of fiduciary duty under Illinois law. Pet. App. 57a. The court awarded damages to the trust of \$250,000, which the court estimated to be the benefit obtained by petitioner from the breaches of duty, though characterizing the "actual monetary benefit" as "difficult to ascertain." Pet. App. 46a. The court added an award of \$35,000 in attorneys' fees to the trust, \$25,000 of which respondent, as successor trustee, was directed to pay to the two brothers who commenced the action. Pet. App. 47a-49a.



6. The Illinois court also imposed a constructive trust on the assets of petitioner and of two affiliated entities in the amount of the judgment against petitioner. The constructive trust expressly included the Springfield mill property and petitioner's beneficial interest in the Curt Bullock Trust. Pet. App. 47a–48a. The effect of this order was to put petitioner's assets, which he might have used toward payment of the judgment, in respondent's control. Over the years following entry of the Illinois judgment in 2002, respondent rejected petitioner's repeated pleas and demands that the property subject to the constructive trust be liquidated to pay the judgment. RE, Vol. 1, Tab M at 3, 15–18.

7. On October 21, 2009, petitioner filed for bankruptcy under Chapter 7 of the Bankruptcy Code seeking a discharge of his debts. Respondent, as successor trustee of the Curt Bullock Trust, filed an adversary proceeding on January 11, 2010, to obtain a ruling excepting petitioner's obligations under the Illinois judgment from discharge under 11 U.S.C. § 523(a)(4). Petitioner answered and, though not a lawyer, defended himself *pro se* in the adversary proceeding. Respondent filed a motion for summary judgment contending that petitioner should be collaterally estopped from contesting issues that were decided by the Illinois court and that the Illinois court's judgment established § 523(a)(4) "defalcation" as a matter of law. Respondent submitted no other evidence in support of the motion, which the bankruptcy court granted. Pet. App. 29a–44a. Though

sharply criticizing respondent for its own administration of the trust, the district court affirmed in an unpublished order. Pet. App. 16a-28a.

8. On further appeal, the United States Court of Appeals for the Eleventh Circuit acknowledged a split among the circuits as to the definition of "defalcation." The court aligned itself with the Fifth, Sixth, and Seventh Circuits to hold that "defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless." Pet. App. 10a-11a. The Eleventh Circuit deemed "self-dealing" to be objectively reckless and from that concluded that petitioner's actions amounted to defalcation sufficient to except petitioner's debt from discharge. Pet. App. 11a.

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## SUMMARY OF ARGUMENT

I.-III. For more than a century, the Court has resisted attempts to broaden the discharge exception that is now found in 11 U.S.C. § 523(a)(4), consistent with the principle that exceptions of particular debts from bankruptcy discharge should be restricted to those plainly expressed. The Court has held that fiduciary fraud, also excepted from discharge by § 523(a)(4), requires a showing of moral turpitude or intentional wrong, not merely constructive fraud. Embezzlement and larceny, the other offenses specified in the section, also require criminal intent. "Defalcation" has never been defined in the statute

and is not a term in common or ordinary use. Under the interpretive maxim *noscitur a sociis*, however, the fact that "several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well." *Beecham v. United States*, 511 U.S. 368, 371 (1994). No reason exists to withhold bankruptcy relief for fiduciary debts that arise from circumstances lacking the degree of culpability commensurate with fraud, embezzlement, and larceny.

The First and Second Circuits' requirement of conscious misbehavior or extreme recklessness, drawing from the scienter requirement of securities law, is the most faithful to the statutory context and overall objectives of bankruptcy law, particularly the paramount "fresh start" policy. As to petitioner's mental state here, there is no indication, much less any finding, that petitioner *knew* that the three loans, made from his father's *inter vivos* life insurance trust and ultimately repaid, were improper. The loans were made in accordance with the wishes of one or both of his parents. The Eleventh Circuit erred in conclusively presuming, in effect, that he did know he was committing a breach of trust, without considering the actual evidence that he did not.

Respondent sought summary judgment relying exclusively on the findings in the underlying state court action. But there was no state court finding that petitioner acted with a culpable mental state. The *only* express judicial finding concerning petitioner's mental state was that he did not appear to have a

malicious motive in borrowing funds from the trust. The burden to produce evidence of the requisite mental state was at all times on respondent. Respondent could have attempted to offer other evidence, *Brown v. Felsen*, 442 U.S. 127, 138–39 (1979), but offered none. Accordingly, petitioner was not shown to have acted with the requisite mental state to have been found to have committed a discharge-ineligible “defalcation.”

IV. Mental state aside, a “failure to account” for entrusted property or a “shortage in accounts” is an element that must be proven to establish the exception. This requirement is consistent with dictionary definitions of “defalcation” likely available at the time of enactment of the 1841 Act, which introduced the term into bankruptcy law. And the deletion of “misappropriation” from the 1978 Act reinforces the interpretation that misappropriations that do not ultimately result in a shortage in accounts do not fall within § 523(a)(4). There was no proof of a failure to account for trust property in petitioner’s case. The loans were repaid with interest. There was no loss of the trust principal. When petitioner resigned as trustee, the net policy value of the trust’s only asset was the same as when his tenure began. The debt sought to be discharged was not based on any calculation of a loss to the trust but was instead only an unexplained estimate of the benefit he received. This does not amount to “defalcation” within the meaning of § 523(a)(4).

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## ARGUMENT

### **I. Exceptions of Debts from Discharge Are Construed to Safeguard the “Fresh Start” That Is the Primary Objective of Individual Bankruptcy.**

The Court has posited that the exceptions of particular debts from bankruptcy discharge “should be confined to those plainly expressed.” *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998) (quoting *Gleason v. Thaw*, 236 U.S. 558, 562 (1915)). This admonition reinforces the Bankruptcy Code’s “fresh start” policy, a foundation of bankruptcy law: “One of the primary purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes.’” *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554–55 (1915)). See 4 COLLIER ON BANKRUPTCY ¶ 523.05 (16th ed. 2012) (“In determining whether a particular debt falls within one of the exceptions of section 523, the statute should be strictly construed against the objecting creditor and liberally in favor of the debtor.”).

The current discharge-exception provision, 11 U.S.C. § 523(a), is basically divisible into two groups of exceptions. See *Grogan v. Garner*, 498 U.S. 279, 287–88 (1991). The first group consists of debts that are *per se* non-dischargeable for various policy reasons: certain taxes, domestic support obligations, educational loans, restitution orders, and the like. The



second group of non-dischargeable debts are the products of wrongdoing, including debts resulting from willful and malicious injury, § 523(a)(6); fraud or certain false representations, § 523(a)(2); and death or injury caused by driving while intoxicated, § 523(a)(9). In this second group is § 523(a)(4)'s exception "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny."<sup>2</sup>

In *Geiger*, the Court considered the proper interpretation of § 523(a)(6), which excludes from discharge any debt "for willful and malicious injury by the debtor to another." 11 U.S.C. § 523(a)(6). The debt in question was a medical malpractice judgment attributable to the debtor's negligent or reckless conduct. The Court held unanimously that the exception covered only acts done with actual intent to cause injury and not all deliberate or intentional acts that lead to injury. Not every intentional tort, the Court held, is excepted from bankruptcy discharge. *Geiger*, 523 U.S. at 64. The Court noted that the judgment creditor's broader proposed interpretation would except even knowing breaches of contract from discharge and found so expansive an interpretation to

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<sup>2</sup> Section 523(a)(11) includes a parallel exception from discharge of debts created by judgments, orders, or settlements "arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union." 11 U.S.C. § 523(a)(11). This exception was added in 1990 in reaction to the savings and loan crisis. See Charles Jordan Tabb, *The Historical Evolution of the Bankruptcy Discharge*, 65 AM. BANKR. L.J. 325, 370 n.363 (1991).



clash with *Gleason's* longstanding rule of narrow construction for exceptions to discharge. *Id.* at 61–62. The Court also pointed out that a broader interpretation would render other portions of § 523 superfluous. *Id.* at 62.

## **II. The Court Has Repeatedly Resisted Expansion of the Defalcation Exception, but Has Not Addressed the Question Presented.**

The term “defalcation” first appeared in the Bankruptcy Act of 1841. Since then, the Court has consistently deflected efforts to expand the reach of the provision in which it appears. The 1841 provision excluded from eligibility for discharge debts “created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity.” Act of Aug. 19, 1841, ch. 9, 5 Stat. 441 (repealed 1843). Construing the statute in *Chapman v. Forsyth*, 43 U.S. (2 How.) 202 (1844), the Court held that a debtor could obtain discharge of non-fiduciary debts even if he also owed non-dischargeable debts that were incurred through defalcation as a public officer or trustee. *Id.* at 208. The Court further held that the debt of a factor who wrongfully retained the money of his principal was a non-fiduciary debt that was eligible for bankruptcy discharge. “The act speaks of technical trusts, and not those which the law implies from the contract. A factor is not, therefore, within the act.” *Id.*

In 1867, Congress enacted a new bankruptcy law that excepted from discharge any "debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character." Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533 (repealed 1878). Construing this provision in *Neal v. Clark*, 95 U.S. 704 (1877) (Harlan, J.), the Court held that a debt created by the "fraud" of the bankrupt

means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality. Such a construction of the statute is consonant with equity, and consistent with the object and intention of Congress in enacting a general law by which the honest citizen may be relieved from the burden of hopeless insolvency. A different construction would be inconsistent with the liberal spirit which pervades the entire bankrupt system.

*Id.* at 709. The Court rejected the view that constructive fraud or gross negligence fell within the exception. Citing the interpretive maxim *noscitur a sociis*, the Court reasoned that "the meaning of a word may be ascertained by reference to the meaning of words associated with it," *id.* at 708, and that the association of "fraud" with "embezzlement" must mean that actual fraud was required by the statute. *Id.* at 709. See also *Upshur v. Briscoe*, 138 U.S. 365 (1891) (under 1867 Act, failure to pay interest under trust

arrangement not breach of technical trust triggering exception); *Hennequin v. Clews*, 111 U.S. 676 (1884) (failure of lender to return collateral was breach of contract, not breach of trust excepted from discharge).

The next comprehensive bankruptcy statute, the Bankruptcy Act of 1898, deemed non-dischargeable those debts "created by . . . fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1979). In *Crawford v. Burke*, 195 U.S. 176 (1904), the Court construed this language to have narrowed the 1867 Act because the limiting phrase "while acting as an officer or in any fiduciary capacity" modified not only "defalcation" but also "fraud, embezzlement, and misappropriation." *Id.* at 189-90. The debtor, a stockbroker who sold his client's stock and was charged with conversion, was held to be entitled to discharge the resulting debt.

In *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) (Cardozo, J.), the Court again rejected an expansionary interpretation of the exception. The Court held that an auto dealer's conversion of the proceeds of a sale by failing to promptly pay the secured inventory lender did not result in a non-dischargeable debt under § 17(4) of the 1898 Act. The Court pointed out that the trial court found that the defendant was not "actuated by willful, malicious or criminal intent in disposing of the car in question." *Id.* at 332. The lender argued that, irrespective of willfulness or malice, the debt arose from fraud or misappropriation

while acting in a fiduciary capacity, but the Court rejected that argument on the ground that "[i]t is not enough that, by the very act of wrongdoing out of which the contested debt arose, the bankrupt has become chargeable as a trustee *ex maleficio*. He must have been a trustee before the wrong without reference thereto." *Id.* at 333. The use of a "trust receipt" to structure the transaction was not enough to change the nature of the transaction from a security arrangement into a trust falling within the discharge exception.

The 1978 Bankruptcy Reform Act introduced the present text of § 523(a)(4) at issue here. Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. The term "misappropriation" was deleted, as recommended by the Commission on the Bankruptcy Laws of the United States.<sup>3</sup> The commission had also recommended the

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<sup>3</sup> Congress relied on the report issued in 1973 by the Commission on the Bankruptcy Laws of the United States in drafting the new Bankruptcy Code. In its proposed model act, the Commission excluded fraud, misappropriation, and defalcation from the analogue for § 523(a)(4). Specifically, the proposed model act provided that "[a] discharge extinguishes all debts of an individual debtor . . . except . . . any liability for embezzlement or larceny." REP. OF THE COMM'N ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 2, at 136 (1973). The Commission explained its rationale for the omissions as follows:

The terms "misappropriation" and "defalcation" are discarded as overbroad and uncertain in meaning. See *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937). The standard of "fraud" is moved to a more appropriate location in clause (2), and

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deletion of "defalcation," which was nonetheless retained in the law. The provision's language was also altered to clarify that embezzlement and larceny were not limited to fiduciary situations, and that only fiduciary fraud was covered, since other frauds fell within subsection (a)(2).

Although the Court's precedents since the 1840s have consistently resisted attempts to expand the scope of what is now the (a)(4) exception, the Court has not addressed the precise meaning of "defalcation." Lower courts seem to agree that not every breach of fiduciary duty amounts to a discharge-ineligible defalcation. "The mere failure to meet an obligation while acting in a fiduciary capacity simply does not rise to the level of defalcation . . . ." *R.E. Am., Inc. v. Garver (In re Garver)*, 116 F.3d 176, 177-80 (6th Cir. 1997); accord *Rutanen ex rel. Quevillon v. Baylis (In re Baylis)*, 313 F.3d 9, 19 (1st Cir. 2002). The cases also agree that the meaning is a question of federal law. *E.g., Otto v. Niles (In re Niles)*, 106 F.3d 1456, 1460 (9th Cir. 1997). But the consensus ends there. The federal circuits fall into three camps regarding the mental state required for a misappropriation or a failure to account to constitute "defalcation" under § 523(a)(4) of the Bankruptcy Code: (1) conscious misbehavior or extreme recklessness, required by the

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the precisely definable term "larceny" is added to the remaining term "embezzlement" to cover conduct clearly within the intended scope of this ground for nondischargeability.

*Id.*, pt. 2, at 139.



First and Second Circuits; (2) known breach of a fiduciary duty, such that the conduct can be characterized as “objectively reckless,” applied by the Eleventh Circuit in this case and by the Fifth, Sixth, and Seventh Circuits; and (3) mere negligence or innocent mistake resulting in a failure to account for entrusted property, applied by the Fourth, Eighth, and Ninth Circuits.

### **1. Conscious Misbehavior or Extreme Recklessness**

The First and Second Circuits require “a mental state embracing intent to deceive, manipulate, or defraud” paralleling the scienter requirement in the well-developed law of securities fraud. *Baylis*, 313 F.3d at 20 (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976)). The standard can be met with a showing of extreme recklessness constituting “an extreme departure from the standards of ordinary care.” *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 1999). The “mere conscious taking of risk associated with the usual torts standard of recklessness” is insufficient. *Baylis*, 313 F.3d at 20. In *Denton v. Hyman (In re Hyman)*, 502 F.3d 61 (2d Cir. 2007), the Second Circuit explicitly aligned itself with the First Circuit and adopted *Baylis*’s conscious misbehavior or extreme recklessness standard: “We believe that these concepts—well understood and commonly applied in the securities law context—strike the proper balance under § 523(a)(4). This standard ensures that the term ‘defalcation’ complements but



does not dilute the other terms of the provision, . . . all of which require a showing of actual wrongful intent." *Id.* at 68.

*Hyman* involved co-owners of an insurance agency. One of the co-owners died. The other co-owner continued to run the agency, while engaging in protracted and ultimately unsuccessful negotiations to buy his deceased co-owner's share from his estate. The estate subsequently sued him in state court and won a \$2.7 million judgment for breach of fiduciary duty. The state court, however, made no findings on Hyman's state of mind. Hyman filed for bankruptcy protection, and the estate brought a proceeding to except the judgment from discharge for "defalcation," relying exclusively on collateral estoppel. The Second Circuit affirmed the bankruptcy court's rejection of this claim, reasoning that the record contained evidence of Hyman's good faith. "[W]e are loath to conclude that an identical issue was necessarily decided or that Hyman had a full and fair opportunity to contest his state of mind." *Id.* at 70.

*Baylis* involved a lawyer acting as co-trustee who was accused of various acts of defalcation. In its analysis, the First Circuit pointed out that the defalcation exception is located in the same sentence with exceptions for fraud, embezzlement, and larceny, all of which require specific intent. *Baylis*, 313 F.3d at 20 (excepting from discharge any debts "for fraud and defalcation while acting as a fiduciary, and embezzlement and larceny generally"). The court reasoned that an act that constitutes a defalcation "must be a

serious one indeed, and some fault must be involved.” *Id.* at 19. “[A] creditor must be able to show that a debtor’s actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny.” *Id.* at 20. The court concluded that requiring “a mental state embracing intent to deceive, manipulate, or defraud,” borrowed from securities law, properly calibrated the meaning of defalcation with the level of culpability of fraud, embezzlement, and larceny also listed in subsection (a)(4), while avoiding redundancy with fiduciary “fraud” by encompassing as well “extreme recklessness,” a “lesser form of intent.” *Id.* (quoting *Ernst & Ernst*, 425 U.S. at 193 n.12, and *Rizek v. SEC*, 215 F.3d 157, 162 (1st Cir. 2000)). The court reversed the lower court’s exception from discharge of all of Baylis’s debts to the trust, but affirmed the exception from discharge to the extent he used trust funds to pay his personal expenses without reimbursement.

## **2. Knowing Breach or Objective Recklessness**

The Eleventh Circuit in this case joined the circuits that have adopted a recklessness standard that is less rigorous than the First and Second Circuits’ standard. *Bullock v. BankChampaign, N.A.* (*In re Bullock*), 670 F.3d 1160 (11th Cir. 2012), Pet. App. 1a–14a. These circuits require varying degrees of willfulness, knowledge, and objective recklessness, but all require something more than “mere negligence.” See, e.g., *FNFS, Ltd. v. Harwood* (*In re Harwood*), 637

F.3d 615 (5th Cir. 2011); *Patel v. Shamrock Floor-covering Servs., Inc. (In re Patel)*, 565 F.3d 963 (6th Cir. 2009); *Meyer v. Rigdon*, 36 F.3d 1375 (7th Cir. 1994).

The Fifth Circuit requires “a willful neglect of duty,” which is “essentially a recklessness standard.” *Schwager v. Fallas (In re Schwager)*, 121 F.3d 177, 184–85 & n.12 (5th Cir. 1997) (quoting *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417, 421 (5th Cir. 1990)). Willfulness is assessed “objectively” based on “what a reasonable person in the debtor’s position knew or reasonably should have known.” *Harwood*, 637 F.3d at 624 (quoting *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001)). The Sixth and Seventh Circuits have recited a standard for defalcation that requires “something more than negligence or mistake, but less than fraud.” *Follett Higher Educ. Grp. v. Berman (In re Berman)*, 629 F.3d 761, 765 n.3 (7th Cir. 2011) (citing *Meyer*, 36 F.3d at 1385)); see *Patel*, 565 F.3d at 970 (labeling the standard as “objectively reckless” and rejecting “defalcation per se”).

### 3. Negligent or Innocent Mistake

The most expansive reading of defalcation withholds discharge for even purely innocent mistakes and has been adopted by the Fourth, Eighth, and Ninth Circuits. *Republic of Rwanda v. Uwimana (In re Uwimana)*, 274 F.3d 806, 811 (4th Cir. 2001) (citing *Pahlavi v. Ansari (In re Ansari)*, 113 F.3d 17, 20 (4th

Cir. 1997)); *Tudor Oaks Ltd. P'ship v. Cochrane* (*In re Cochrane*), 124 F.3d 978, 984 (8th Cir. 1997); *Sherman v. SEC* (*In re Sherman*), 658 F.3d 1009, 1017 (9th Cir. 2011); *Blyler v. Hemmeter* (*In re Hemmeter*), 242 F.3d 1186, 1190–91 (9th Cir. 2001). In these circuits, “negligence or even an innocent mistake which results in misappropriation or failure to account is sufficient.” *Uwimana*, 274 F.3d at 811. *See Sherman*, 658 F.3d at 1017 (“[E]ven innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required.”) (quoting *Hemmeter*, 242 F.3d at 1190).

#### **4. The Requirement of Failure to Account**

The circuits also appear to conflict on the degree to which they require a creditor seeking to except an alleged defalcation debt from discharge to show that it has sustained a loss. The Eleventh Circuit here did not require that respondent prove a loss of principal; the court regarded the Illinois court’s judgment for disgorgement of the purported benefit alone as sufficient. Other circuits appear to require a demonstration of the loss of the entrusted property. *Commonwealth Land Title Co. v. Blaszak* (*In re Blaszak*), 397 F.3d 386, 390 (6th Cir. 2005) (“resulting loss” is required element); *Garver*, 116 F.3d at 178 (same); *see Lewis v. Scott* (*In re Lewis*), 97 F.3d 1182, 1186 (9th Cir. 1996) (requiring “fail[ure] to account fully for money received”).

### **III. Conscious Misbehavior or Extreme Recklessness Should Be Required to Except Fiduciary Debts from Discharge—and Is Absent Here.**

The Court's task is to define an undefined statutory term that is not in common use. Contemporary dictionaries offer an inconclusive menu of alternative meanings. *E.g.*, BLACK'S LAW DICTIONARY 479 (9th ed. 2009) ("1. Embezzlement. 2. Loosely, the failure to meet an obligation; a nonfraudulent default."). Petitioner submits that the First and Second Circuits' requirement of conscious misbehavior or extreme recklessness, drawing from the scienter requirement of securities law, is the most faithful to the statutory context and overall objectives of bankruptcy law. That standard comports with "the commonsense canon of *noscitur a sociis*—which counsels that a word is given more precise content by the neighboring words with which it is associated." *Freeman v. Quicken Loans, Inc.*, \_\_\_ U.S. \_\_\_, 132 S. Ct. 2034, 2042 (2012) (quoting *United States v. Williams*, 553 U.S. 285, 294 (2008)). See generally ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* § 31 (2012).

The Eleventh Circuit's definition of defalcation is simply too lax to be ranked among the likes of "fraud . . . , embezzlement, or larceny" found in the same clause, all of which require findings of wrongful intent. See *Neal*, 95 U.S. at 708–09 (applying *noscitur a sociis* to determine meaning of "fraud"). Specifically, fraud in a fiduciary relationship as contemplated by



§ 523(a)(4) requires fraudulent intent. *See id.* at 709 (fiduciary fraud involves “moral turpitude or intentional wrong”); *McClellan v. Cantrell*, 217 F.3d 890, 893–94 (7th Cir. 2000). The other offenses listed in § 523(a)(4), embezzlement and larceny, require criminal intent. “Embezzlement is the fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come. It differs from larceny in the fact that the original taking of the property was lawful, or with the consent of the owner, while in larceny the felonious intent must have existed at the time of the taking.” *Moore v. United States*, 160 U.S. 268, 269–70 (1895). Cases construing § 523(a)(4) follow *Moore*’s classic definition. Larceny under § 523(a)(4) has been defined to be a wrongful taking of personal property “with intent to convert it or deprive the owner” of it. *Ormsby v. First Am. Title Co. (In re Ormsby)*, 591 F.3d 1199, 1205 (9th Cir. 2010) (citation omitted). Embezzlement is the “fraudulent conversion of the property of another by one who is already in lawful possession of it.” *Sherman v. Potapov (In re Sherman)*, 603 F.3d 11, 13 (1st Cir. 2010) (citation omitted).

To construe “defalcation” more expansively, so as to allow an exception from discharge based on a significantly lower threshold of wrongdoing, would be out of step with the accompanying provisions in the statute. “That several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well.” *Beecham v. United States*, 511 U.S. 368, 371 (1994). No reason exists to withhold bankruptcy relief for fiduciary



debts that arise from circumstances lacking the degree of culpability commensurate with fraud, embezzlement, and larceny. "The maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress." *Jarecki v. G. D. Searle & Co.*, 367 U.S. 303, 307 (1961). Mere negligence or even recklessness should not be enough to warrant an exception from discharge under § 523(a)(4). An honest trustee who, for instance, invests imprudently and produces a loss of *res* that results in his being held civilly liable should not be denied a bankruptcy discharge. Requiring a showing of "a mental state embracing intent to deceive, manipulate, or defraud," *Ernst & Ernst*, 425 U.S. at 193 n.12, or "extreme recklessness," would ensure that a fresh start is denied only for the most serious misconduct that results in a loss to another. *Hyman*, 502 F.3d at 68; *Baylis*, 313 F.3d at 20. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (*scienter* is "wrongful state of mind").

As to petitioner's mental state here, there is no indication, much less any finding, that petitioner *knew* that the three loans made from his father's *inter vivos* life insurance trust were improper. The Eleventh Circuit erred in conclusively presuming, in effect, that he did know, without considering the actual evidence, invoking a purportedly "objective" standard and declining to examine the particular circumstances of petitioner's case. *Cf. Field v. Mans*,

516 U.S. 59, 70–75 (1995) (justifiable reliance is all that is required to establish fraud under § 523(a)(2)(A); must consider qualities and characteristics of individual plaintiff, not simply hypothetical “reasonable man”). A *per se* rule that any act or omission by a fiduciary that could be deemed self-dealing under state law is conclusively presumed to constitute “defalcation” strays too far off course from bankruptcy’s fresh start policy. This is especially so in light of the proliferation of fiduciary obligations in recent decades, many imposed by statute. *See Angelle v. Reed (In re Angelle)*, 610 F.2d 1335, 1339 (5th Cir. 1980). The capabilities of persons acting as trustees vary widely, as petitioner’s case exemplifies. Petitioner’s father was sold a life insurance policy and advised to create a trust for estate planning purposes. Petitioner was unaware that he was even named as trustee for at least two years, and he had no legal or comparable training in trust administration. To hold trustees civilly liable under a one-size-fits-all standard may be sound as a matter of state trust law, but to deny a bankruptcy discharge without consideration of the debtor’s individual circumstances loses sight of the proper role of discharge exceptions in bankruptcy law: to withhold relief only from true malefactors who cause serious harm. Here, the Eleventh Circuit erred by imputing to petitioner knowledge of an impropriety that he lacked.

The record shows nothing beyond petitioner’s acting in accordance with his parents’ wishes with respect to his father’s primary asset, a whole life

insurance policy with a \$1,000,000 death benefit. The policy's cash value was borrowed to pay premiums to keep the policy in force (no quarrel from anyone there); to make a loan to his mother, as requested by his father, the trust settlor; and to make two other secured loans to his mother and him. Petitioner was advised in these transactions by the agent who sold the policy. The three loans were repaid in full, with interest. If petitioner had sought and obtained the beneficiaries' consents, there would have been no basis for complaint. See RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. c(3) (2007). But petitioner did not believe the loans were improper, and regarded them instead as safe investments of the cash value. At the end of petitioner's tenure as trustee, the policy had the same net value and benefit that it had when his father created the trust. The Eleventh Circuit should have considered these circumstances, along with the state court's findings, and concluded that a "defalcation" did not occur. Imputed knowledge that any self-dealing could be a violation of trust law, a ramification of which he had no actual knowledge, is insufficient to establish the mental state needed to except a debt from discharge for "defalcation" under § 523(a)(4).

Without imputed knowledge of impropriety, respondent's case for defalcation falls apart. Respondent sought summary judgment relying exclusively on the findings in the underlying state court action. But there was no state court finding that petitioner acted with a culpable mental state. The *only* judicial finding concerning petitioner's mental state was that

he “did not appear to have a malicious motive in borrowing funds from the trust.” Pet. App. 45a. The burden to produce evidence of the requisite mental state was at all times on respondent. *See Palmacci v. Umpierrez*, 121 F.3d 781, 787 (1st Cir. 1997). Respondent could have attempted to offer other evidence, *Brown v. Felsen*, 442 U.S. 127, 138–39 (1979), but did not. Like the creditor in *Hyman*, by relying exclusively on the state court’s findings, respondent failed to carry its burden to demonstrate that petitioner acted with a wrongful state of mind sufficient to support a finding of defalcation under § 523(a)(4). The state court’s finding of no apparent ill intent, coupled with the absence of loss of *res*, falls far short of establishing the sort of grave misconduct that should deprive a financially ruined individual from the statutory last refuge of discharge in bankruptcy.

#### **IV. Failure to Account for Entrusted Property Is an Essential Element of “Defalcation”—and Is Absent Here As Well**

Mental state aside, the cases frequently recite that a “failure to account” for entrusted property or a “shortage in accounts” is an element that must be proven to establish the exception now found in § 523(a)(4). “‘Defalcation’ refers to a failure to produce funds entrusted to a fiduciary . . . .” *Guerra v. Fernandez-Rocha (In re Fernandez-Rocha)*, 451 F.3d 813, 817 (11th Cir. 2006) (quoting *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993)); *Hemmeter*, 242 F.3d at 1190–91 (“The definition of defalcation includes both

the misappropriation of trust funds or money held in any fiduciary capacity; and the failure to properly account for such funds." (internal quotation marks omitted)); *Cundy v. Woods (In re Woods)*, 284 B.R. 282, 291 (D. Colo. 2001) ("[I]t was legal error to conclude that defalcation occurred since there was no failure of the assumed fiduciary to account for the *res* . . . ."). This requirement is consistent with dictionary definitions of "defalcation" likely available at the time of enactment of the 1841 Act, which introduced the term into bankruptcy law. See, e.g., SAMUEL JOHNSON, A DICTIONARY OF THE ENGLISH LANGUAGE 6L (1755) ("diminution; abatement; excision of any part of a customary allowance"); NOAH WEBSTER, AN AMERICAN DICTIONARY OF THE ENGLISH LANGUAGE 56 (1828) ("The act of cutting off, or deducting a part; deduction; diminution; abatement; as, let him have the amount of his rent without *defalcation*."). And the deletion of "misappropriation" from the 1978 Act—a "baffling word," *Herbst*, 93 F.2d at 512, added by the 1898 Act—suggests that misappropriations that do not ultimately result in a shortage in accounts no longer fall within § 523(a)(4), if they did before.

This key element is absent in petitioner's case. There was no failure to account for the entrusted property and no loss of the trust principal. When petitioner resigned as trustee, the net policy value of the trust's only asset was the same as when his tenure began. The investments of cash value chosen by petitioner, to a large degree for the benefit of his



mother—the spouse of the trust settlor—were loans that were repaid periodically, with interest. The first loan, to his mother only, was actually requested by his father. The other two secured loans were made to himself and his mother. The judgment against petitioner was for the state court's unexplained estimate of the benefit he received, not a reckoning for any loss; there was no loss from the loans. At the least, a *prima facie* case for “defalcation” should include a demonstration of a failure to account for the entrusted property. The burden of production would then shift to the errant fiduciary to show he acted without the wrongful state of mind that would disqualify the debt from discharge.

The loans here were made without the consent of each of the trust's beneficiaries, which could have cured any defect, and so were technical breaches of trust. But the evidence was that petitioner, upon his resignation as trustee, still produced the entrusted property intact. Petitioner thus was entitled to discharge of the debt in question on this additional independent ground.

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## CONCLUSION

This was a squabble about family trust administration that escalated perversely, spawning more than a decade of litigation and culminating in financial disaster for petitioner. No showing has been made that he engaged in the sort of culpable misconduct causing serious harm to others that would



warrant excepting a debt from discharge. For the foregoing reasons, the Eleventh Circuit's judgment affirming the order of summary judgment against petitioner should be vacated, and the case remanded for further proceedings consistent with the Court's opinion.

Respectfully submitted,

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December 13, 2012

# **RESPONDENT'S BRIEF**

**In The  
Supreme Court of the United States**

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**RANDY CURTIS BULLOCK,**

*Petitioner,*

**v.**

**BANKCHAMPAIGN, N.A.,**

*Respondent.*

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**On Writ Of Certiorari To The  
United States Court Of Appeals  
For The Eleventh Circuit**

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**BRIEF OF RESPONDENT**

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**QUESTION PRESENTED**

The Bankruptcy Code excepts from discharge all debts incurred on account of defalcation while acting in a fiduciary capacity. Bullock, while a trustee of a trust, made self-dealing loans that harmed the trust. Can Bullock discharge his debts to the trust incurred on account of his self-dealing?

# TABLE OF CONTENTS

|                                                                                                                         | Page |
|-------------------------------------------------------------------------------------------------------------------------|------|
| QUESTION PRESENTED.....                                                                                                 | i    |
| TABLE OF CONTENTS .....                                                                                                 | ii   |
| TABLE OF AUTHORITIES .....                                                                                              | iv   |
| STATEMENT OF THE CASE.....                                                                                              | 1    |
| SUMMARY OF ARGUMENT .....                                                                                               | 4    |
| ARGUMENT.....                                                                                                           | 5    |
| I. Any Act of Self-Dealing by a Trustee Will<br>Always Be Defalcation While Acting in a<br>Fiduciary Capacity .....     | 5    |
| A. The Duty of Loyalty Is the Highest Duty<br>of a Trustee to the Beneficiaries .....                                   | 6    |
| B. Bullock's Breach of His Duty of Loy-<br>alty by Self-Dealing Constitutes a De-<br>falcation Under Any Standard ..... | 7    |
| 1. Breach of the Duty of Loyalty by<br>Self-Dealing Is an Extremely Reck-<br>less Act.....                              | 8    |
| a. Bullock's Self-Dealing Was Ex-<br>tremely Reckless in Light of<br>His Duty of Loyalty.....                           | 9    |
| b. The Extreme Recklessness Stan-<br>dard Is an Objective Standard .....                                                | 12   |
| c. Bullock's Reasoning for Making<br>Self-Dealing Loans Does Not<br>Make the Loans Less Self-<br>Dealing.....           | 14   |

## TABLE OF CONTENTS – Continued

|                                                                                                                                                                                         | Page |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| 2. Bullock's Breach of His Duty of Loyalty by Self-Dealing Satisfies the Objectively Reckless Standard .....                                                                            | 15   |
| 3. Breaching the Duty of Loyalty by Self-Dealing Is Always Greater Misconduct Than Negligence; Therefore, Bullock's Conduct Is Non-Dischargeable Even Under a Negligence Standard ..... | 18   |
| II. Bullock Incorrectly Argues That "Failure to Account" Is a Necessary Element of Defalcation Under Section 523(a)(4).....                                                             | 20   |
| A. The Statute Does Not Contain Any Requirement of a Failure to Account in Order to Commit a Defalcation.....                                                                           | 20   |
| B. Bullock Failed to Account to the Trust by Failing to Turn Over the Profits That He Earned.....                                                                                       | 22   |
| III. Protection of the Trust's Beneficiaries Takes Precedence Over Bullock's Fresh Start.....                                                                                           | 24   |
| IV. Contrary to Bullock's Contention, Bank-Champaign Neither Urges Nor Requires Any Expansion of the Defalcation Exception to Discharge.....                                            | 26   |
| CONCLUSION.....                                                                                                                                                                         | 27   |



## TABLE OF AUTHORITIES

|                                                                                                                           | Page       |
|---------------------------------------------------------------------------------------------------------------------------|------------|
| CASES                                                                                                                     |            |
| <i>Bussian v. RJR Nabisco, Inc.</i> , 223 F.3d 286 (5th Cir. 2000).....                                                   | 6          |
| <i>Carlisle Cashway, Inc. v. Johnson (In re Johnson)</i> , 691 F.2d 249 (6th Cir. 1982).....                              | 16         |
| <i>Cazenovia College v. Renshaw (In re Renshaw)</i> , 222 F.3d 82 (2d Cir. 2000).....                                     | 25         |
| <i>Central Hanover Bank &amp; Trust Co. v. Herbst</i> , 93 F.2d 510 (2d Cir. 1937).....                                   | 24         |
| <i>Central States, Southeast &amp; Southwest Areas Pension Fund v. Central Transport, Inc.</i> , 472 U.S. 559 (1985)..... | 6          |
| <i>Chapman v. Forsyth</i> , 43 U.S. 202 (1844).....                                                                       | 26         |
| <i>Corse v. Hemmeter (In re Hemmeter)</i> , 242 F.3d 1186 (9th Cir. 2001).....                                            | 20         |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328 (1934).....                                                           | 26, 27     |
| <i>Denton v. Hyman (In re Hyman)</i> , 502 F.3d 61 (2d Cir. 2007).....                                                    | 7, 9       |
| <i>Forsdick v. Turgeon</i> , 812 F.2d 801 (2d Cir. 1987).....                                                             | 25         |
| <i>Grogan v. Garner</i> , 498 U.S. 279 (1991).....                                                                        | 14, 25, 27 |
| <i>Lewis v. Scott (In re Lewis)</i> , 97 F.3d 1182 (9th Cir. 1996).....                                                   | 20         |
| <i>Magruder v. Drury</i> , 235 U.S. 106 (1914) .....                                                                      | 23, 24     |
| <i>Meinhard v. Salmon</i> , 164 N.E. 545 (1928) ....                                                                      | 11, 12, 18 |

## TABLE OF AUTHORITIES – Continued

|                                                                                                                  | Page          |
|------------------------------------------------------------------------------------------------------------------|---------------|
| <i>Meyer v. Rigdon (In re Rigdon)</i> , 36 F.3d 1375<br>(7th Cir. 1994) .....                                    | 19, 20        |
| <i>Mosser v. Darrow</i> , 341 U.S. 267 (1951).....                                                               | 23            |
| <i>NDSL, Inc. v. Patnoude</i> , 1:12-CV-1161, 2012<br>U.S. Dist. LEXIS 173694 (W.D. Mich. Dec. 7,<br>2012) ..... | 21            |
| <i>Neal v. Clark</i> , 95 U.S. 701 (1877).....                                                                   | 26            |
| <i>Niehoff v. Maynard</i> , 299 F.3d 41 (1st Cir. 2002).....                                                     | 7             |
| <i>Office of Thrift Supervision v. Felt (In re Felt)</i> ,<br>255 F.3d 220 (5th Cir. 2001) .....                 | 18            |
| <i>Pahlavi v. Ansari (In re Ansari)</i> , 113 F.3d 17<br>(4th Cir. 1997) .....                                   | 6             |
| <i>Patel v. Shamrock Flooring, Inc. (In re Patel)</i> ,<br>565 F.3d 963 (6th Cir. 2009) .....                    | 8, 16, 17     |
| <i>Pegram v. Herdrich</i> , 530 U.S. 211 (2000) .....                                                            | 6             |
| <i>Republic of Rwanda v. Uwimana (In re<br/>Uwimana)</i> , 274 F.3d 806 (4th Cir. 2001).....                     | 6             |
| <i>Rutanen v. Baylis (In re Baylis)</i> , 313 F.3d 9 (1st<br>Cir. 2002) .....                                    | <i>passim</i> |
| <i>Safeco Ins. Co. v. Burr</i> , 551 U.S. 47 (2007).....                                                         | 18            |
| <i>Schwager v. Fallas (In the Matter of Schwager)</i> ,<br>121 F.3d 177 (5th Cir. 1997) .....                    | 8, 15         |
| <i>Sherman v. S.E.C. (In re Sherman)</i> , 658 F.3d<br>1009 (9th Cir. 2011).....                                 | 8             |
| <i>Stevens v. Briles (In re Briles)</i> , 16 Fed. Appx.<br>698 (9th Cir. 2001) .....                             | 21            |

## TABLE OF AUTHORITIES – Continued

|                                                                                                | Page      |
|------------------------------------------------------------------------------------------------|-----------|
| <i>Tudor Oaks Ltd. P'ship v. Cochrane (In re Cochrane)</i> , 124 F.3d 978 (8th Cir. 1997)..... | 8         |
| <i>United States v. Jicarilla Apache Nation</i> , 131 S. Ct. 2313 (2011).....                  | 6, 11, 13 |
| <i>Wolf v. Fried</i> , 373 A.2d 734 (1977) .....                                               | 19        |
| <i>Woods v. City Nat. Bank &amp; Trust Co. of Chicago</i> , 312 U.S. 262 (1941) .....          | 12        |
| <i>Woodworking Enter. v. Baird (In re Baird)</i> , 114 Bankr. 198 (9th Cir. BAP 1990).....     | 18        |

## STATUTES

|                                    |               |
|------------------------------------|---------------|
| 11 U.S.C. § 523(a)(4).....         | <i>passim</i> |
| 760 Ill. Comp. Stat. 5/11(a) ..... | 21            |

## OTHER AUTHORITIES

|                                                                                   |       |
|-----------------------------------------------------------------------------------|-------|
| Black's Law Dictionary 417 (6th ed. 1990).....                                    | 6, 20 |
| G. Bogert, G. Bogert & A. Hess, THE LAW OF TRUSTS AND TRUSTEES (3d ed. 2012)..... | 22    |
| Restatement (Second) of Trusts (1959).....                                        | 22    |
| Restatement (Third) of Trusts (2012) .....                                        | 22    |

## STATEMENT OF THE CASE

In December 1978, Curt Bullock established the Curt Bullock Trust No. 2 (the "Trust"). Pet. App., 33a. Curt Bullock appointed his son, the Petitioner (hereinafter, "Bullock"), as the trustee of the Trust. *Id.* The corpus of the Trust was a life insurance policy on the life of Curt Bullock. Pet. App., 33a. The beneficiaries of the trust were Bullock and Bullock's four siblings. Pet. App., 17a. Bullock executed the Trust document as the trustee and accepted the legal obligations of a trustee. Pet. App., 53a.

After becoming the trustee of the Trust, Bullock made three self-dealing loans. Pet. App., 54a. Bullock first made a loan to and for the benefit of his mother, Imogene Bullock, in the amount of \$117,545.96. The purpose of this first loan was to enable Imogene Bullock to repay a debt that she owed to the family garage-construction business, a business in which Bullock held an equity interest. Pet. App., 2a. Bullock made a second loan in 1984 in the amount of \$80,257.04, to his mother and himself to purchase certificates of deposit, which they later cashed in and used toward the purchase of a garage fabrication mill in Ohio. Pet. App., 17a. Third, in 1990, Bullock loaned \$66,223.96 to his mother and himself to purchase real estate. Pet. App., 17a.

Thus, on account of the three loans, Bullock received substantial personal benefits. First, his business received repayment on a loan to Bullock's mother thus providing Bullock's business with additional

capital. Second, Bullock was able to purchase a garage fabrication mill, a business that Bullock owned and operated and from which he profited. Third, Bullock was able to make a profitable investment in real estate. Bullock repaid all three loans to the trust with interest but retained all of the personal benefits that he accrued from the self-dealing loans.

In 2001, two of Bullock's brothers and Trust beneficiaries sued Bullock in Illinois state court, for breaches of fiduciary duty. Pet. App., 17a. The Illinois court found that the loans from the Trust were for the benefit of Bullock and therefore self-dealing. Pet. App., 54a. The Illinois court concluded that Bullock had breached his fiduciary duties to the Trust and the beneficiaries. Pet. App., 54a. Accordingly, the Illinois court found Bullock liable to the Trust for the personal benefits he obtained from the self-dealing loans in the amount of \$250,000 and for the Trust's legal expenses of \$35,000. Pet. App., 47a. To secure Bullock's obligations to the Trust, the Illinois court imposed a constructive trust on certain of Bullock's assets and on certain assets of companies that Bullock owned. Pet. App., 47a.<sup>1</sup>

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<sup>1</sup> While Bullock has made certain allegations concerning his attempts to sell some of the assets subject to the constructive trusts, such allegations have never been put into the evidence in record in this case and therefore constitute mere speculation.

In October 2009, Bullock filed for bankruptcy relief pursuant to Chapter 7, Title 11, United States Code, 11 U.S.C. § 101, *et seq.* (the “Bankruptcy Code”). Pet. App., 30a. BankChampaign, as successor trustee to the Trust, filed an adversary proceeding in Bullock’s bankruptcy case, objecting to Bullock’s discharge of his obligations to the Trust. Pet. App., 30a. Specifically, BankChampaign alleged that Bullock’s obligations to the Trust were non-dischargeable pursuant to 11 U.S.C. § 523(a)(4), as a debt incurred by defalcation while acting as a fiduciary. Pet. App., 30a. The bankruptcy court held that Bullock’s self-dealing breaches of his fiduciary duties constituted a defalcation. Pet. App., 43a-44a. The United States District Court for the Northern District of Alabama affirmed the bankruptcy court’s judgment. Pet. App., 16a. The United States Court of Appeals for the Eleventh Circuit affirmed the judgment. Pet. App., 1a. This Court granted Certiorari.

Bullock requests that this Court allow him to self-deal in trust assets, reap a substantial benefit from the self-dealing, harm the Trust and the innocent beneficiaries, and then discharge in bankruptcy his obligations to the Trust. This is not what Congress intended when it made debts on account of defalcations by a fiduciary non-dischargeable.





## SUMMARY OF ARGUMENT

Bullock's self-dealing with the Trust corpus constitutes a defalcation while acting in a fiduciary capacity, resulting in a non-dischargeable debt. There is no issue whether a trustee of an express trust holds a fiduciary capacity. He does. Courts, however, have articulated three different general standards for determining whether a fiduciary's misconduct constitutes a defalcation: extreme recklessness, objective recklessness, and negligence. By disregarding the high standard of loyalty that a trustee owes to a trust and beneficiaries, Bullock's act of self-dealing satisfies each or any of these standards. Thus, Bullock's debt to the Trust is properly non-dischargeable regardless of which standard applies.

Under an extreme recklessness standard, a defalcation occurs when the fiduciary's acts are an extreme departure from the standards of ordinary care of fiduciaries. By knowingly and intentionally lending Trust assets for his personal benefit, Bullock's acts departed extremely from the absolute duty of loyalty that the law demands of fiduciaries.

Likewise, Bullock's acts of making loans for his own benefit (and from which he did in fact benefit) satisfy the objectively reckless standard. Bullock willfully made loans in his own interest and benefit, and with complete disregard to the interest or benefit of the Trust. These acts of self-dealing were objectively reckless and therefore constituted a defalcation by Bullock.

Additionally, Bullock's loans for his own benefit were more than negligent. Bullock did not commit an unwitting or careless default of a fiduciary duty; he *deliberately* made self-dealing loans from the Trust to himself and for his own self-interest. Therefore, Bullock's misconduct was at least negligent. Bullock's debts to the Trust are therefore non-dischargeable under the negligence standard for determining defalcation, as well as under any other standard.



## ARGUMENT

### **I. Any Act of Self-Dealing by a Trustee Will Always Be Defalcation While Acting in a Fiduciary Capacity.**

Of all of the duties that a trustee owes to trust beneficiaries, the duty of loyalty is the most sacrosanct. Accordingly, breaching the duty of loyalty is the most egregious breach of trust a trustee can commit. The Bankruptcy Code excepts from discharge "any debt . . . (4) for . . . defalcation while acting in a fiduciary capacity." 11 U.S.C. § 523(a)(4). Because a breach of the duty of loyalty by self-dealing is so egregious, it will always be a defalcation.

Courts define defalcation as "[a] monetary deficiency through breach of trust by one who has the management or charge of funds," *Rutanen v. Baylis* (*In re Baylis*), 313 F.3d 9, 18 (1st Cir. 2002) (citing the Oxford English Dictionary (2d ed. 1989)), or the "misappropriation of trust funds or money held in any

fiduciary capacity; [or the] failure to properly account for such funds," *Pahlavi v. Ansari (In re Ansari)*, 113 F.3d 17, 20 (4th Cir. 1997) (citing Black's Law Dictionary 417 (6th ed. 1990)), or "the failure to meet an obligation" or a "nonfraudulent default." *Republic of Rwanda v. Uwimana (In re Uwimana)*, 274 F.3d 806, 811 (4th Cir. 2001) (citing Black's Law Dictionary 427 (7th ed. 1999)). All of the definitions of defalcation contemplate a breach of a trustee's fiduciary obligations to its beneficiaries, such as occurred in this case.

#### **A. The Duty of Loyalty Is the Highest Duty of a Trustee to the Beneficiaries.**

A trustee owes many duties to its beneficiaries, see generally *Central States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc.*, 472 U.S. 559 (1985), but a trustee's duty of loyalty is "[t]he most fundamental duty owed by the trustee to the beneficiaries of the trust." *Pegram v. Herdrich*, 530 U.S. 211, 224 (2000) (quoting 2A A. Scott & W. Fratcher, *The Law of Trusts* § 170, 311 (4th ed. 1987)); *United States v. Jicarilla Apache Nation*, 131 S. Ct. 2313, 2336 (2011) ("Among the most fundamental fiduciary obligations of a trustee is to administer the trust solely in the interest of the beneficiaries") (internal citations omitted). Accordingly, the duty of loyalty is the highest duty known to the law. *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 294 (5th Cir. 2000) (discussing trustee obligations under ERISA). Likewise, a breach of the duty of loyalty by self-dealing is

one of the most serious offenses that the law recognizes. *Niehoff v. Maynard*, 299 F.3d 41, 51 (1st Cir. 2002) (recognizing that under Delaware law, allegations of “self-dealing significantly taint the fiduciary relationship” and that “[t]hey implicate *serious* breaches of loyalty.”) (emphasis added).

It is in this context that the Bankruptcy Code excepts from discharge *any* debt incurred on account of defalcations while acting in a fiduciary capacity. If a trustee’s self-dealing breach of the most fundamental duty of loyalty did not constitute a defalcation under 11 U.S.C. § 523(a)(4), then the statute would be meaningless because nothing would ever count as a defalcation.

### **B. Bullock’s Breach of His Duty of Loyalty by Self-Dealing Constitutes a Defalcation Under Any Standard.**

Courts have articulated three different standards for determining what degree of misconduct constitutes a defalcation under 11 U.S.C. § 523(a)(4). Some courts have held that defalcation requires an act of extreme recklessness similar to scienter in the context of securities law. *Denton v. Hyman (In re Hyman)*, 502 F.3d 61 (2d Cir. 2007) (stating that defalcation requires a showing of conscious misbehavior or extreme recklessness – a showing akin to the showing required for scienter in the securities law context); *Baylis*, 313 F.3d 9 (1st Cir. 2002) (ruling that defalcation requires something close to a showing of

extreme recklessness). Other courts have held that an objectively reckless act is sufficient misconduct for a defalcation. *Patel v. Shamrock Flooring, Inc. (In re Patel)*, 565 F.3d 963 (6th Cir. 2009) (finding that a debtor must have been objectively reckless in failing to properly account for or allocate funds); *Schwager v. Fallas (In the Matter of Schwager)*, 121 F.3d 177 (5th Cir. 1997) (holding that willful neglect of fiduciary duty constitutes a defalcation – essentially a recklessness standard). Finally, some courts have adopted a negligence standard for determining a defalcation by a fiduciary. *Sherman v. S.E.C. (In re Sherman)*, 658 F.3d 1009, 1017 (9th Cir. 2011) (“Even innocent acts of failure to fully account for money received in trust will be held as non-dischargeable defalcations; no intent to defraud is required”) (internal citations omitted); *Tudor Oaks Ltd. P’ship v. Cochrane (In re Cochrane)*, 124 F.3d 978 (8th Cir. 1997) (stating that defalcation includes the innocent default of a fiduciary who fails to account fully for money received; an individual may be liable for defalcation without having the intent to defraud).

Under any of the foregoing standards, breaching the duty of loyalty by self-dealing is always a defalcation.

### **1. Breach of the Duty of Loyalty by Self-Dealing Is an Extremely Reckless Act.**

If (assuming *arguendo*) “extreme recklessness” is the correct standard for generally determining



whether misconduct is a defalcation, Bullock's conduct of making self-dealing loans was extremely reckless and therefore was a defalcation. The extreme recklessness standard requires "a showing of conscious misbehavior or extreme recklessness – a showing akin to the showing required for scienter in the securities law context." *In re Hyman*, 502 F.3d at 68. Here, Bullock acted extremely recklessly by knowingly taking trust assets for personal loans, hoping to profit thereby; and he did.

**a. Bullock's Self-Dealing Was Extremely Reckless in Light of His Duty of Loyalty.**

In *Baylis*, the First Circuit articulated an extreme recklessness standard for non-dischargeability pursuant to 11 U.S.C. § 523(a)(4). *Baylis*, 313 F.3d at 20. The court in *Baylis* however, made a crucial distinction between a strict test for non-dischargeability for debts incurred by a trustee by reason of self-dealing, and debts resulting from other types of conduct that are governed by less stringent standards. *Id.* *Baylis* made clear that there is a defalcation within the meaning of section 523(a)(4) if a trustee breaches his or her duty of loyalty. Where, as here, a trustee engages in self-dealing the trustee is held "to a very strict standard," and cannot discharge the resulting debt. As stated in *Baylis*:

In evaluating whether there is a defalcation of a fiduciary duty, there must be reference to the duty involved. Of the various duties,



the duty of loyalty is “[t]he most fundamental duty owed . . . the duty of a trustee to administer the trust solely in the interest of the beneficiaries.” 2A A. Scott, *The Law of Trusts* § 170 (W.F. Fratcher ed., 4th ed. 2001).

*Id.* at 20. As further stated in *Baylis*:

Defalcation may be presumed from breach of the duty of loyalty, the duty not to act in the fiduciary’s own interest when that interest comes or may come into conflict with the beneficiaries’ interest.

A trustee occupies a position in which the courts have fixed a very high and very strict standard for his conduct whenever his personal interest comes or may come into conflict with his duty to the beneficiaries.

*Id.* at 20-21 (internal citation omitted). The court there concluded that the debtor’s use of trust money for personal attorney’s fees and to settle a lawsuit brought against him personally was “in violation of his duty of loyalty,” and thus, that the debtor-trustee’s “actions as to this component of the debt do constitute defalcation.” *Id.* at 22. Where a trustee borrows money from the trust for personal use in violation of the trust instrument, the trustee’s breach of the duty of loyalty constitutes a defalcation which is non-dischargeable as a matter of law under § 523(a)(4).

Bullock in this case unquestionably breached his duty of loyalty by self-dealing. Pet. App., at 57a (“It is

undisputed that Defendant lent money to entities in which he had a financial interest or to relatives. This placed him in a position where he would be tempted to act in his interest, possibly against the interests of the beneficiaries.”). As this Court has stated with regard to the duty of loyalty and self-dealing,

Among the most fundamental fiduciary obligations of a trustee is “to administer the trust solely in the interest of the beneficiaries.” 2A A. Scott & W. Fratcher, *Law of Trusts* § 170, p. 311 (4th ed. 1987); see *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928) (Cardozo, C. J.) (“Not honesty alone, but the punctilio of an honor the most sensitive,” is “the standard of behavior” for trustees “bound by fiduciary ties”).

*United States v. Jicarilla Apache Nation*, 131 S. Ct. 2313, 2336 (2011). It is this conduct of self-dealing that is characterized as “extremely reckless” by the First Circuit. *Baylis*, 313 F.3d at 22. In essence, the court imposed a strict rule governing non-dischargeability, ruling that self-dealing constitutes a defalcation under section 523(a)(4). Thus, because of the serious nature of a breach of the duty of loyalty, even if extreme recklessness is the correct standard for determining defalcation, Bullock’s breach of the duty of loyalty by self-dealing is a defalcation.

**b. The Extreme Recklessness Standard Is an Objective Standard.**

Bullock erroneously states that his conduct was not extremely reckless because Bullock did not subjectively know “that the three loans made from his father’s *inter vivos* life insurance trust were improper.” Pet. Br., 23. First, Bullock’s argument posits ignorance of the law as an excuse; an argument that the Illinois state court rejected when it held Bullock liable under Illinois law. *See* Pet. App., 53a. Such an argument is especially misplaced with regard to trustees, who are charged to strictly comply with their duties. *Woods v. City Nat. Bank & Trust Co. of Chicago*, 312 U.S. 262, 269 (1941) (quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) (“Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries ‘at a level higher than that trodden by the crowd.’”)).

Furthermore, Bullock mistakenly equates defalcation with fraud, arguing that because he did not have specific intent to defraud the Trust and the beneficiaries, he did not commit a defalcation. *See* Pet. Br., 23-24 (citing the fraud requirements under 11 U.S.C. § 523(a)(2) as articulated in *Field v. Mans*, 516 U.S. 59 (1995)). Bullock incorrectly concludes, therefore, that “[i]mputed knowledge that any self-dealing could be a violation of trust law, a ramification of which he had no actual knowledge, is insufficient to establish the mental state needed to except a debt from discharge for ‘defalcation’ under § 523(a)(4).” Pet. Br., 25.

That conclusion is mistaken because even under the extreme recklessness standard for defalcation, a trustee need not have specific intent to commit defalcation. *Baylis*, 313 F.3d at 18-19 (“we find that a defalcation requires some degree of fault, closer to fraud, without the necessity of meeting a strict specific intent requirement.”). Defalcation is an objective standard regarding conduct, not a subjective standard relating to mental states. *Id.* at 17 (“Defalcation is to be measured objectively.”). In *Baylis*, the court stated that a creditor “need not prove that a debtor acted knowingly or willfully, in the sense of specific intent” and that “a debtor fiduciary may not escape the exclusion from discharge of his debt arising out of defalcation by saying he had no specific intent.” *Id.* at 20. All that a creditor must show is “that a debtor’s actions were so egregious that they come close to the level that would be required to prove fraud, embezzlement, or larceny.” *Id.*

In this case, Bullock’s act of self-dealing was so egregious that it was extremely reckless. As the court in *Baylis* explained, extreme recklessness is “an extreme departure from the standards of ordinary care.” *Id.* at 20 (quoting *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198 (1st Cir. 2000)). The standard of care for a trustee of a trust is clear: Bullock must administer the Trust solely in the interest of the beneficiaries. *Jicarilla*, 131 S. Ct. at 2336. Bullock failed to do so. Instead, he used the Trust corpus for his own benefit. Bullock made loans from the Trust that benefitted himself and his companies. Pet. App.,

53a-54a. Thus, by disregarding his fiduciary obligations to administer the Trust for the beneficiaries and making self-beneficial loans to himself, Bullock's conduct was an extreme departure from the most fundamental duties of a trustee. Bullock's actions of self-dealing constitute a defalcation and the debts incurred on account of the defalcation are non-dischargeable.

Nonetheless, Bullock assigns error to the Circuit Court below, objecting that the court "conclusively presume[ed], in effect, that he did know, without considering the actual evidence . . . and declining to examine the particular circumstances of petitioner's case." Pet. App., 23. However, the Circuit Court below reviewed the facts *de novo* (Pet. App., 5a.), the same standard of review the District Court applied. Pet. App., 19a. The Bankruptcy Court applied collateral estoppel to the facts as determined by the Illinois state court. Pet. App., 38a. Thus, the Circuit Court below relied on the same record as the Bankruptcy Court; the detailed record of the Illinois state court. Bullock never appealed or challenged the facts of that record and is now collaterally estopped from doing so. See *Grogan v. Garner*, 498 U.S. 279, 285 n.11 (1991).

**c. Bullock's Reasoning for Making Self-Dealing Loans Does Not Make the Loans Less Self-Dealing.**

Bullock errs further by arguing that his self-dealing was permitted because he made some of the



loans, in whole or in part, for the benefit of his mother or at the request of Bullock's father – the Trust settlor. Pet. Br., 2, 25, 28. Bullock, however, did not owe either his mother or his father a duty of loyalty. Bullock owed a duty of loyalty to the Trust beneficiaries. Bullock breached the duty of loyalty by self-dealing when he made the loans, even if a portion of the loan proceeds went to his mother. Pet. App., 54a-55a (finding by the Illinois court that "using trust assets for the benefit of family members is also considered self-dealing."). The duty of loyalty prevents Bullock from finding quarter for his self-dealing in accordance with his father's request or in the fact that his mother was a borrower. Bullock's self-dealing is a defalcation while acting in a fiduciary capacity. The Court should not permit Bullock to discharge a debt that the Illinois state court found to arise from his self-dealing.

## **2. Bullock's Breach of His Duty of Loyalty by Self-Dealing Satisfies the Objectively Reckless Standard.**

Bullock's self-dealing as a trustee is objectively reckless conduct that constitutes a defalcation. The objectively reckless standard is a willfulness standard. *Schwager*, 121 F.3d at 185 ("A 'willful neglect' of fiduciary duty constitutes a defalcation – essentially a recklessness standard"). Objective recklessness "does not require actual intent, as does fraud." *Id.* The objective standard prevents ignorance of the law from becoming a defense to non-dischargeability and



provides an incentive to trustees to apprise themselves of their obligations under the law. *Carlisle Cashway, Inc. v. Johnson (In re Johnson)*, 691 F.2d 249, 257 (6th Cir. 1982).

In *In re Patel*, the Sixth Circuit addressed the issue of whether self-dealing was objectively reckless conduct. *Patel*, 565 F.3d 963 (6th Cir. 2009). In *Patel*, the debtor was the president of Empire Builders of Michigan, Inc. *Id.* at 966. Empire Builders was engaged in home construction. *Id.* Empire incurred debt to Shamrock Floorcovering for materials and supplies. *Id.* Michigan law imposed a trust on Empire's revenue whereby Empire held certain funds in trust to pay its suppliers and materialmen, such as Shamrock. *Id.*

As Empire completed construction projects and received payment, Empire used some of the funds to cover its general and administrative expenses and only then paid some funds to Shamrock. *Id.* at 966-67. Empire eventually collapsed and the debtor filed for bankruptcy. *Id.* at 967. Shamrock objected to the debtor's discharge of the balance due to Shamrock. *Id.* The bankruptcy court ruled that the debt to Shamrock was dischargeable, but the district court reversed. *Id.*

On appeal, the circuit court affirmed the district court. The court found that the debtor had "paid his own operating expenses – including payroll, utilities, taxes and wages to himself for services rendered as

president – before he sent any money to Shamrock.” *Id.* at 971. The court reasoned that

the objective fact that monies paid into the building contract fund were used for purposes other than to pay laborers, subcontractors or materialmen first is sufficient to constitute defalcation under section 523(a)(4) so long as the use was not the result of mere negligence or a mistake of fact.

*Id.* at 970. The court therefore concluded that the debtor “recklessly misallocated funds and failed to pay his subcontractors first as required by [Michigan law].” *Id.* at 971.

Just as the debtor in *Patel* committed a defalcation by self-dealing, so too did Bullock in this case. Bullock made loans from the Trust to himself in violation of his duty to administer the Trust for the sole benefit of the beneficiaries. Specifically, the Illinois state court found that “[t]he Defendant borrowed against the cash value of the life insurance policy on three occasions. He then loaned the proceeds to his mother and to business entities that he had an interest in.” Pet. App., 50a. Bullock’s intent with regard to making the loans is immaterial. *Patel*, 565 F.3d at 970 (“subjective, deliberate wrongdoing was not an element required to establish defalcation.”).

Bullock’s act of making a loan from trust property was willful and therefore objectively reckless. Willfulness in this context “is measured objectively by

reference to what a reasonable person in the debtor's position knew or should have known." *Office of Thrift Supervision v. Felt (In re Felt)*, 255 F.3d 220, 226 (5th Cir. 2001). See also *Safeco Ins. Co. v. Burr*, 551 U.S. 47 (2007) (defining recklessness for purposes of the Fair Credit Reporting Act under an objective standard as "action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known."). Bullock, as trustee of the Trust, is held to "[n]ot honesty alone, but the punctilio of an honor the most sensitive." *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928). Bullock disregarded his obligations and engaged in self-dealing. This conduct is objectively reckless in light of Bullock's high obligations to the Trust. Thus, under an "objectively reckless" standard, Bullock's obligations to BankChampaign are not dischargeable under § 523(a)(4).

### **3. Breaching the Duty of Loyalty by Self-Dealing Is Always Greater Misconduct Than Negligence; Therefore, Bullock's Conduct Is Non-Dischargeable Even Under a Negligence Standard.**

Even under a negligence standard for determining defalcation Bullock's debt should be non-dischargeable. When adopting a negligence standard for determining defalcation, some courts have held that all breaches of a fiduciary obligation constitute a defalcation. *Woodworking Enter v. Baird (In re Baird)*, 114 Bankr. 198, 204 (9th Cir. BAP 1990) ("In the

context of section 523(a)(4), the term 'defalcation' includes innocent, as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts."). Under this standard, Bullock's conduct is non-dischargeable as well.

Breach of the duty of loyalty by self-dealing is more than negligent conduct. See, e.g., *Wolf v. Fried*, 373 A.2d 734 (1977). In *Wolf*, the Supreme Court of Pennsylvania considered a corporate director's negligence to be a breach of his fiduciary duty. *Wolf*, 373 A.2d at 735. The court recognized, however, that negligence was a lesser standard than self-dealing, stating "[e]ven in the absence of fraud, self-dealing, or proof of personal profit or wanton acts of omission or commission, the directors of a corporation may be held personally liable where they have been imprudent, wasteful, careless and negligent and such actions have resulted in corporate losses." *Id.* Likewise, while not directly addressing self-dealing or breach of the duty of loyalty, in *Meyer v. Rigdon*, the Seventh Circuit concluded that "a knowing breach of fiduciary duty is more culpable than a mere negligent breach of fiduciary duty." *Meyer v. Rigdon (In re Rigdon)*, 36 F.3d 1375, 1385 (7th Cir. 1994).

In this case, Bullock's conduct constituted more than negligence as it was a willful breach of the duty of loyalty. Bullock willfully made loans from the Trust to himself. Pet. App., 50a ("The Defendant borrowed against the cash value of the life insurance policy on three occasions. He then loaned the proceeds to his mother and to business entities he had an interest

in.”). Because Bullock’s act of making a self-dealing loan was willful, it was more than negligent. *Rigdon*, 36 F.3d at 1385. Accordingly, the Court should affirm that Bullock’s obligations to BankChampaign are non-dischargeable even if the standard for determining defalcation is mere negligence.

## **II. Bullock Incorrectly Argues That “Failure to Account” Is a Necessary Element of Defalcation Under Section 523(a)(4).**

### **A. The Statute Does Not Contain Any Requirement of a Failure to Account in Order to Commit a Defalcation.**

Bullock, through a strained grammatical construction, posits that a defalcation requires both (a) a misappropriation of trust funds, and (b) a failure to properly account for trust funds. Pet. Br., 26-27. In fact, the term defalcation includes either a misappropriation or a failure to account, but does not require both. The Black’s Law Dictionary on which Bullock relies defines defalcation as “misappropriation of trust funds or money held in any fiduciary capacity; failure to properly account for such funds.” Black’s Law Dictionary 417 (6th ed. 1990).<sup>2</sup>

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<sup>2</sup> Petitioner cites *Corse v. Hemmeter (In re Hemmeter)*, 242 F.3d 1186 (9th Cir. 2001), for a definition of defalcation. *Hemmeter*, in turn, cites *Lewis v. Scott (In re Lewis)*, 97 F.3d 1182, 1185 (9th Cir. 1996), which relies on Black’s Law Dictionary 417 (6th ed. 1990) as defining defalcation as “misappropriation of trust



The Court should read the two provisions as alternative definitions, not as multiple elements of a single definition. *See generally NDSL, Inc. v. Patnoudé*, 1:12-CV-1161, 2012 U.S. Dist. LEXIS 173694 at \*10 n.2 (W.D. Mich. Dec. 7, 2012) (construing multiple definition entries separated by semicolons). *See also Stevens v. Briles (In re Briles)*, 16 Fed. Appx. 698 (9th Cir. 2001) (finding that a single act “constitutes defalcation *either* as a failure to account for property *or* as a misappropriation of property.”) (emphasis added). By making self-dealing loans Bullock committed defalcation by misappropriation of the Trust corpus.

Most importantly, even if failure to account were a necessary element for committing a defalcation, Bullock did fail to account for the Trust assets in this case. A failure to account is not, as Bullock implies, simply a failure to maintain control of the assets, but includes a failure to report to beneficiaries concerning the financial performance of the trust. 760 Ill. Comp. Stat. 5/11(a) (“Every trustee at least annually shall furnish to the beneficiaries . . . a current account showing the receipts, disbursements and inventory of the trust estate.”). In this case, Bullock failed to report profits that rightfully belonged to the Trust. The Illinois court found that Bullock failed to account for the trust assets. Pet. App., 58a. Accordingly, Bullock committed a defalcation by failing to account for

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funds or money held in any fiduciary capacity; failure to properly account for such funds.”



the Trust assets. His debts on account of this defalcation are therefore non-dischargeable.

**B. Bullock Failed to Account to the Trust  
by Failing to Turn Over the Profits  
That He Earned.**

Even if, as Bullock argues, defalcation requires an element of “resulting loss” (Pet. Br., 20), Bullock caused a loss to the Trust by retaining the benefits of his own self-dealing. Courts of equity universally recognize that a trustee who breaches a fiduciary duty is “accountable for any profit accruing to the trust through a breach of trust.” Restatement (Third) of Trusts § 205 (2012). *See also* Restatement (Second) of Trusts § 205 (1959) (“if the trustee commits a breach of trust, he is chargeable with . . . (b) any profit made by him through the breach of trust.”). As the comment to the Restatement explains:

The trustee is chargeable with any profit made by him through the improper disposition or use of trust property. Thus, if the trustee makes an unauthorized investment with trust money which results in a profit, he is chargeable with the profit.

Restatement (Third) of Trusts § 205 (2012); G. Bogert, G. Bogert & A. Hess, *THE LAW OF TRUSTS AND TRUSTEES* § 862 (3d ed. 2012) (“Another rule of damages provides that a trustee is liable for any profit he has made through his breach of trust even though the trust has suffered no loss. Thus the trustee will be

held liable for profits made through a prohibited dealing with trust property even though the trust received or paid fair market value for the property.”). Courts have therefore held that one measure of making a trust whole for a trustee’s breach of duty is the profits that the trustee obtains on account of the breach. See *Magruder v. Drury*, 235 U.S. 106 (1914); *Mosser v. Darrow*, 341 U.S. 267 (1951) (finding a trustee liable for profits earned by his employees).

In *Magruder*, this Court addressed the propriety of a trustee earning a profit from the use of trust assets. In *Magruder*, Drury was a trustee of a decedent’s estate and a trust created under the decedent’s will. *Id.* at 111. Drury was likewise an owner of a real estate brokerage firm, Arms & Drury. *Id.* at 118. As trustee of the trust, Drury directed the trust to make certain commercial loans to various borrowers. *Id.* Drury collected a commission from the borrowers. *Id.*

This Court held that Drury could not retain the commission and should pay the commission to the trust. *Id.* at 119-20. The Court reasoned that “It is a well settled rule that a trustee can make no profit out of his trust.” *Id.* at 119. The Court based its reasoning on the inviolable duty of loyalty, stating:

This rule in such cases springs from his duty to protect the interests of the estate, and not to permit his personal interest to in any wise conflict with his duty in that respect. The intention is to provide against any possible selfish interest exercising an influence which can interfere with the faithful

discharge of the duty which is owing in a fiduciary capacity.

\* \* \*

It is the relation of the trustee to the estate which prevents his dealing in such way as to make a personal profit for himself.

*Id.* at 119-20.

In this case, Bullock derived a profit in the amount of \$250,000 from the self-dealing loans and caused the trust to incur litigation costs in the amount of \$35,000. Pet. App., 47a. It is this profit that courts recognize as a loss to the Trust. Bullock must pay this profit to the Trust for the Trust to be whole. The Court should not condone Bullock's self-dealing simply because Bullock was ultimately able to repay the loans. Rather, the Court should find that the debt is non-dischargeable, thus requiring Bullock to make the Trust whole by turning over the profits that he earned by wrongfully diverting trust assets. *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937) (finding that debtor committed defalcation by retaining trustee's expenses that a court subsequently determined the debtor owed to the trust).

### **III. Protection of the Trust's Beneficiaries Takes Precedence Over Bullock's Fresh Start.**

Bullock's privilege of discharging his debts is subordinate to the rights of the Trust beneficiaries to

be protected. Discharge is available only to the “honest but unfortunate debtor.” *Grogan*, 498 U.S. at 287 (citing *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)). Thus, Congress determined that certain acts by a debtor will prevent the debtor from obtaining a discharge. *Id.* at 287 (stating that § 523(a) “reflect[s] a congressional decision to exclude from the general policy of discharge certain categories of debts.”). Bullock’s defalcation by self-dealing is such an act.

Nonetheless, Bullock argues that the fresh start policy takes precedence over all other policies. Pet. Br., 9. However, such a construction would thwart congressional intent to protect beneficiaries and maintain the high standards of loyalty expected from fiduciaries. *Cazenovia College v. Renshaw (In re Renshaw)*, 222 F.3d 82, 86 (2d Cir. 2000) (“there are circumstances where giving a debtor a fresh start in life is not the paramount concern and *protection of the creditor becomes more important*. For that reason, Congress in the Bankruptcy Code created several exceptions to the general rule that debts may be discharged in bankruptcy.”) (emphasis added); *Forsdick v. Turgeon*, 812 F.2d 801, 802 (2d Cir. 1987) (“While the code therefore reflects a strong public policy of providing debtors with fresh starts, congress has also determined that *certain competing public policy interests shall take precedence*. These competing concerns are reflected in exceptions that congress has enacted to the general rule that debts are dischargeable in bankruptcy.”) (emphasis added).

#### **IV. Contrary to Bullock's Contention, BankChampaign Neither Urges Nor Requires Any Expansion of the Defalcation Exception to Discharge.**

Despite Bullock's arguments otherwise, finding Bullock's debts to the Trust non-dischargeable will not require an "expansion" of the defalcation exception under § 523(a)(4). Bullock invokes *Chapman v. Forsyth*, 43 U.S. 202 (1844), for the idea that this Court "has repeatedly resisted expansion of the defalcation exception." Pet. Br., 11. *Chapman's* central holding was that, under the statute then in existence, fiduciary defalcations were non-dischargeable only where the fiduciary acted under an express or technical trust. *Chapman* fully supports that Bullock's conduct in this case should be held non-dischargeable. Whether *Chapman* stands for "resisting" some "expansion" of the meaning of § 523(a)(4) is beside the point because no expansion of § 523(a)(4) is needed to uphold the non-dischargeability of Bullock's debt. The current statute could be squarely limited to *Chapman's* requirement of an express trust, and Bullock's conduct would still be non-dischargeable.

Likewise, Bullock's arguments from *Neal v. Clark*, 95 U.S. 701 (1877) and *Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) do not support a finding that Bullock's debts by self-dealing are dischargeable. In *Neal*, the Court determined that the fiduciary fraud section required actual fraud; not constructive fraud. *Neal*, 95 U.S. at 709. *Neal* is inapplicable because the instant case deals with



fiduciary defalcation, not fraud. In *Davis*, this Court refused to impose fiduciary status on a debtor *ex maleficio*. *Davis*, 293 U.S. at 333. *Davis* is irrelevant because this case does not include imposition of fiduciary status “*ex maleficio*”; rather Bullock’s fiduciary status derives from expressly assuming the duties of a trustee.

BankChampaign is not arguing that the Court should expand the meaning of the term defalcation. Rather, BankChampaign encourages the Court to simply apply the term as understood in its context of § 523(a). *Grogan*, 498 U.S. at 287, n.13 (“In determining the meaning of the statute, we look not only to the particular statutory language, but to the design of the statute as a whole and to its object and policy”) (internal citations omitted). Congress included the fiduciary defalcation exception to discharge for just this type of situation: to protect innocent beneficiaries from the disloyalty of their trustee by preserving their claims against the trustee. Bullock breached his duty of loyalty by self-dealing and should not be able to discharge his obligations to the Trust.

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## CONCLUSION

The exception to discharge on account of a fiduciary’s defalcation protects innocent beneficiaries from the disloyalty of their trustees. Bullock breached the inviolable duty of loyalty by self-dealing with the Trust assets. Accordingly, the Court should hold that



Bullock's debts to the Trust are non-dischargeable and affirm the ruling of the Circuit Court.

Respectfully submitted,

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# **REPLY BRIEF**

RECORD  
AND  
BRIEFS

No. 11-1518

Supreme Court, U.S.  
FILED

FEB 11 2013

**In The  
Supreme Court of the United States**

OFFICE OF THE CLERK  
SUPREME COURT, U.S.

RANDY CURTIS BULLOCK,

*Petitioner,*

v.

BANKCHAMPAIGN, N.A.,

*Respondent.*

**On Writ Of Certiorari To The United States  
Court Of Appeals For The Eleventh Circuit**

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February 11, 2013

## TABLE OF CONTENTS

|                                                                                                                                                | Page |
|------------------------------------------------------------------------------------------------------------------------------------------------|------|
| TABLE OF CONTENTS.....                                                                                                                         | i    |
| TABLE OF AUTHORITIES .....                                                                                                                     | iii  |
| ARGUMENT.....                                                                                                                                  | 1    |
| I. A State Court Finding of Fiduciary Self-Dealing Does Not Render the Fiduciary's Resulting Debt a <i>Per Se</i> Bankruptcy Defalcation ..... | 1    |
| A. Ignorance of the Law Is No Excuse—Except When It Is.....                                                                                    | 2    |
| B. Not Every Breach of Fiduciary Duty Is a “Defalcation” .....                                                                                 | 9    |
| C. Not Every Instance of Self-Dealing Is a “Defalcation” .....                                                                                 | 11   |
| D. The Statutory Text, Context, and History Indicate That a Culpable Mental State Is Required to Establish Defalcation .....                   | 14   |
| 1. Contradictory dictionary definitions supply no answers .....                                                                                | 15   |
| 2. The government's statutory context argument is overextended.....                                                                            | 15   |
| 3. Applying <i>noscitur a sociis</i> as petitioner urges would have no undesirable collateral consequences.....                                | 16   |
| 4. The anti-surplusage canon would not be violated .....                                                                                       | 17   |

## TABLE OF CONTENTS – Continued

|                                                                                                                    | Page |
|--------------------------------------------------------------------------------------------------------------------|------|
| 5. The government's historical-practice<br>argument is unenlightening .....                                        | 18   |
| II. The Fresh Start Policy Is Embodied in the<br><i>Gleason</i> Rule and Reinforced by the Rule<br>of Lenity ..... | 19   |
| III. Failure to Produce the Entrusted Property<br>Is Required for "Defalcation" .....                              | 20   |
| CONCLUSION .....                                                                                                   | 23   |

## TABLE OF AUTHORITIES

|                                                                                                               | Page        |
|---------------------------------------------------------------------------------------------------------------|-------------|
| CASES                                                                                                         |             |
| <i>Am. Express Travel Related Servs. Co. v. Hashemi (In re Hashemi)</i> , 104 F.3d 1122 (9th Cir. 1996).....  | 8           |
| <i>BedRoc Ltd., LLC v. United States</i> , 541 U.S. 176 (2004).....                                           | 16–17       |
| <i>In re Birkenstock</i> , 87 F.3d 947 (7th Cir. 1996).....                                                   | 6           |
| <i>Bruner v. United States (In re Bruner)</i> , 55 F.3d 195 (5th Cir. 1995) .....                             | 6           |
| <i>C &amp; J Rentals, Inc. v. Purdy (In re Purdy)</i> , 231 B.R. 310 (Bankr. E.D. Mo. 1999) .....             | 22          |
| <i>Central Hanover Bank &amp; Trust Co. v. Herbst</i> , 93 F.2d 510 (2d Cir. 1937).....                       | 17–18       |
| <i>Cheek v. United States</i> , 498 U.S. 192 (1991).....                                                      | 3–4, 5, 8–9 |
| <i>Conn. Nat’l Bank v. Germain</i> , 503 U.S. 249 (1992).....                                                 | 17          |
| <i>Consumer United Ins. Co. v. Bustamante (In re Bustamante)</i> , 239 B.R. 770 (Bankr. N.D. Ohio 1999) ..... | 22          |
| <i>Crandon v. United States</i> , 494 U.S. 152 (1990).....                                                    | 19          |
| <i>Denton v. Hyman (In re Hyman)</i> , 502 F.3d 61 (2d Cir. 2007).....                                        | 17          |
| <i>Gilbert v. United States</i> , 370 U.S. 650 (1962).....                                                    | 7           |
| <i>Gleason v. Thaw</i> , 236 U.S. 558 (1915).....                                                             | 19–20       |
| <i>Grogan v. Garner</i> , 498 U.S. 279 (1991).....                                                            | 10          |
| <i>Groh v. Ramirez</i> , 540 U.S. 551 (2004).....                                                             | 5           |



## TABLE OF AUTHORITIES – Continued

|                                                                                                       | Page       |
|-------------------------------------------------------------------------------------------------------|------------|
| <i>Kawauhau v. Geiger</i> , 523 U.S. 57 (1998).....                                                   | 6, 16      |
| <i>Local Loan Co. v. Hunt</i> , 292 U.S. 234 (1934) .....                                             | 12         |
| <i>In re Maurice</i> , 21 F.3d 767 (7th Cir. 1994).....                                               | 8–9        |
| <i>Meyer v. Rigdon</i> , 36 F.3d 1375 (7th Cir. 1994) .....                                           | 10         |
| <i>Morissette v. United States</i> , 342 U.S. 246 (1952).....                                         | 16         |
| <i>Moskal v. United States</i> , 498 U.S. 103 (1990) .....                                            | 19         |
| <i>Mosser v. Darrow</i> , 341 U.S. 267 (1951).....                                                    | 12         |
| <i>Neder v. United States</i> , 527 U.S. 1 (1999) .....                                               | 7          |
| <i>Patel v. Shamrock Floorcovering Servs., Inc. (In re Patel)</i> , 565 F.3d 963 (6th Cir. 2009)..... | 10         |
| <i>Pearson v. Callahan</i> , 555 U.S. 223 (2009) .....                                                | 5          |
| <i>Ratzlaf v. United States</i> , 510 U.S. 135 (1994) .....                                           | 4–5        |
| <i>Rutanen ex rel. Quevillon v. Baylis (In re Baylis)</i> , 313 F.3d 9 (1st Cir. 2002) .....          | 10, 13, 17 |
| <i>State v. McRae</i> , 983 A.2d 286 (Conn. App. Ct. 2009) .....                                      | 8          |
| <i>State v. Papandrea</i> , 991 A.2d 617 (Conn. App. Ct. 2010) .....                                  | 8          |
| <br>CONSTITUTIONAL PROVISIONS                                                                         |            |
| U.S. Const. art. I, § 8, cl. 4 .....                                                                  | 11         |

## TABLE OF AUTHORITIES – Continued

|                                                                                                                  | Page         |
|------------------------------------------------------------------------------------------------------------------|--------------|
| <b>STATUTES AND REGULATIONS</b>                                                                                  |              |
| 11 U.S.C. § 523(a)(1)(C).....                                                                                    | 5            |
| 11 U.S.C. § 523(a)(4).....                                                                                       | 7, 8, 10, 15 |
| 11 U.S.C. § 523(a)(6).....                                                                                       | 6, 15, 16    |
| 11 U.S.C. § 523(a)(19).....                                                                                      | 16           |
| 31 U.S.C. § 5322 .....                                                                                           | 5            |
| Act of Aug. 19, 1841, ch. 9, 5 Stat. 441, 614<br>(repealed 1843).....                                            | 18, 20       |
| Act of Mar. 3, 1843, ch. 82, 5 Stat. 614 .....                                                                   | 18           |
| Act of July 1, 1898, ch. 541, § 17(4), 30 Stat.<br>550-51 (repealed 1978).....                                   | 16, 18       |
| Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat.<br>2549 .....                                                  | 11, 18, 20   |
| Act of Apr. 20, 2005, Pub. L. No. 109-8, 119<br>Stat. 23 .....                                                   | 11           |
| <b>RULES</b>                                                                                                     |              |
| U.S. Supreme Court Rule 32.3.....                                                                                | 2            |
| <b>OTHER AUTHORITIES</b>                                                                                         |              |
| BLACK’S LAW DICTIONARY (9th ed. 2009) .....                                                                      | 18           |
| MARK GROSSMAN, POLITICAL CORRUPTION IN<br>AMERICA: AN ENCYCLOPEDIA OF SCANDALS,<br>POWER, AND GREED (2003) ..... | 8            |
| WAYNE R. LAFAYE, CRIMINAL LAW (4th ed. 2003) .....                                                               | 8            |

## TABLE OF AUTHORITIES – Continued

|                                                                                                    | Page   |
|----------------------------------------------------------------------------------------------------|--------|
| ANTONIN SCALIA & BRYAN A. GARNER, READING<br>LAW: THE INTERPRETATION OF LEGAL TEXTS<br>(2012)..... | 19, 20 |

**ARGUMENT****I. A State Court Finding of Fiduciary Self-Dealing Does Not Render the Fiduciary's Resulting Debt a *Per Se* Bankruptcy Defalcation.**

The precise issue before the Court is whether the Illinois state court's finding of self-dealing, on which respondent relied exclusively in seeking summary judgment, is conclusive as to whether petitioner committed a discharge-disqualifying "defalcation," even in the face of uncontradicted evidence that the petitioner lacked knowledge that his actions were unlawful under Illinois trust law and the state court's additional findings that he acted without any apparent ill motive and that the loans in issue were all repaid in full, with interest.

Other than the state court findings, respondent offered no evidence in support of its summary judgment motion granted by the bankruptcy court. In this Court, respondent asserts that "the Circuit Court below relied on the same record as the Bankruptcy Court; the detailed record of the Illinois state court." (R. Br. 14.) But this assertion is incorrect. The complete record from the Illinois state court was not before the bankruptcy court, the district court, or the Eleventh Circuit. The only submissions from respondent were the Illinois court's two orders, the complaint and answer in that case, and the Illinois

summary judgment motion, without exhibits.<sup>1</sup> (RE, Vol. 1, Tabs J & K.) Respondent neither submitted nor relied on evidentiary material from the Illinois proceedings.

Respondent and its *amici* offer three different positions on the meaning of “defalcation” as it applies to this case: (1) the Richard Aaron, *et al.* *amici* argue that any breach of fiduciary duty under state law is a defalcation under bankruptcy law; (2) respondent argues that whatever is characterized as self-dealing under non-bankruptcy law automatically constitutes bankruptcy defalcation; and (3) the United States contends that defalcation occurs “where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized.” (U.S. Br. 20.) Each of these positions shares a common assumption: that petitioner’s unawareness that his actions were unlawful and his good faith are irrelevant. Before turning to the particular arguments about defalcation’s meaning, petitioner begins with an examination of that common assumption.

#### **A. Ignorance of the Law Is No Excuse— Except When It Is.**

Respondent and its *amici* contend throughout their briefs that petitioner is charged with knowledge

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<sup>1</sup> Pursuant to Rule 32.3, the parties have submitted a letter to the Clerk jointly proposing to lodge with the Court the trust instrument itself.

of all of the restrictions on a trustee under Illinois law, and that his avowed unawareness of the legal principle involved is no excuse and thus entirely irrelevant. But the Court has held that the general principle that citizens are charged with knowledge of the law is not inviolate. In *Cheek v. United States*, 498 U.S. 192 (1991), the issue was whether the defendant's objectively unreasonable but professed belief that the tax laws were being unconstitutionally enforced was a defense to charges of federal tax evasion and failure to file tax returns. The defendant, who was not a lawyer, testified that he had been advised by a lawyer that his beliefs were correct and had attended seminars where these beliefs were reinforced. The government countered with evidence of the defendant's contrary knowledge, such as his attendance at trials of other tax resisters where their views were rejected by courts. The district court ultimately instructed the jury that an objectively unreasonable view of the tax laws was not a defense. The defendant was convicted and his case was accepted for review by the Court.

The case turned on the meaning of the statutory term "willfully," which was an element of the offenses of which the defendant was convicted. The Court explained that ignorance of the law was in fact relevant because willful conduct was required:

The general rule that ignorance of the law or a mistake of law is no defense to criminal prosecution is deeply rooted in the American legal system. . . . Based on the notion



that the law is definite and knowable, the common law presumed that every person knew the law. This common-law rule has been applied by the Court in numerous cases construing criminal statutes.

The proliferation of statutes and regulations has sometimes made it difficult for the average citizen to know and comprehend the extent of the duties and obligations imposed by the tax laws. Congress has accordingly softened the impact of the common-law presumption by making specific intent to violate the law an element of certain federal criminal tax offenses.

*Id.* at 199–200 (internal citations omitted). The Court noted that the standard for statutory willfulness is the “voluntary, intentional violation of a known legal duty.” *Id.* at 201 (citation omitted). The Court accordingly held that the instruction that the defendant’s belief must be objectively reasonable was erroneous. “Characterizing a particular belief as not objectively reasonable transforms the inquiry into a legal one and would prevent the jury from considering it.” *Id.* at 203.

Exceptions to the “ignorance of the law is no excuse” maxim are not confined to tax law. The Court identified another such exception in *Ratzlaf v. United States*, 510 U.S. 135 (1994), in which the defendant appealed his conviction under a federal statute prohibiting the structuring of financial transactions to evade currency reporting requirements. The Court

again analyzed the meaning of “willfully,” this time in the anti-structuring statute,<sup>4</sup> and held that the defendant was improperly convicted because the jury was not instructed that he must be found to have known that the structuring in which he was engaged was unlawful. As the Court explained, “we are unpersuaded by the argument that structuring is so obviously ‘evil’ or inherently ‘bad’ that the ‘willfulness’ requirement is satisfied irrespective of the defendant’s knowledge of the illegality of structuring.” *Id.* at 146. *See also Pearson v. Callahan*, 555 U.S. 223, 231 (2009) (“The protection of qualified immunity applies regardless of whether the government official’s error is ‘a mistake of law, a mistake of fact, or a mistake based on mixed questions of law and fact.’”) (quoting *Groh v. Ramirez*, 540 U.S. 551, 567 (2004) (Kennedy, J., dissenting)).

The *Cheek* definition of “willfully,” requiring actual knowledge of a violation of the law, has been carried over into the exception to bankruptcy discharge found in § 523(a)(1)(C), which provides, in pertinent part: “A discharge under section 727 . . . of this title does not discharge an individual debtor from any debt . . . for a tax or a customs duty . . . with respect to which the debtor made a fraudulent return or *willfully* attempted in any manner to evade or defeat such tax.” 11 U.S.C. § 523(a)(1)(C) (emphasis added). Echoing *Cheek*, courts construing this section

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<sup>4</sup> 31 U.S.C. § 5322.

require the creditor to prove that “the debtor . . . both (1) know that he has a tax duty under the law, and (2) voluntarily and intentionally attempt to violate that duty.” *In re Birkenstock*, 87 F.3d 947, 952 (7th Cir. 1996) (citing *Bruner v. United States (In re Bruner)*, 55 F.3d 195, 197 (5th Cir. 1995)).<sup>3</sup>

The common thread in situations where willfulness has been required is the existence of a specialized legal regime encountered by people who are ill-equipped to cope with it when armed only with an average citizen’s experience and capabilities. In these instances, the Court has determined that Congress did not intend to visit harsh consequences on violators without proof that they knew their actions actually violated the law. Fiduciary law, encountered by untrained lay people with increasing frequency, is just such a regime, littered with traps for the unwary. Petitioner’s case is an exemplar. The trust was created by petitioner’s father who contributed his life insurance policy to establish it. The beneficiaries were his children. At first, petitioner had no idea that he was trustee. The first loan, to his mother, was requested by his father. It is hardly self-evident to a lay person that such a loan could be improper. Nor is

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<sup>3</sup> Willfulness is also an element of the exception of debts from discharge found in 11 U.S.C. § 523(a)(6), which excludes debts “for willful and malicious injury by the debtor to another entity or to the property of another entity.” In *Kawaauhau v. Geiger*, 523 U.S. 57, 64 (1998), the Court held that this language did not reach negligent or reckless torts, which are dischargeable.

impropriety apparent in the other two loans, to his mother and himself, which were secured and ultimately used in a family business. Petitioner was advised in these actions by the family's insurance agent. All of the loans were fully repaid. None of the conduct was so manifestly evil that the legal order demands that petitioner be charged with knowledge of the law when it comes to assessing his eligibility for discharge in bankruptcy. Faced with these facts, respondent retorts that petitioner "did not owe either his mother or his father a duty of loyalty." (R. Br. 15.) Few would agree.

The discharge exception at issue here, paragraph (a)(4), does not include an express willfulness component or specify a required mental state for any of the listed offenses of fiduciary fraud, defalcation, embezzlement, or larceny. This is likely because these terms found their way into the discharge-exception statute more than 140 years ago, and the requisite culpable mental states were regarded as commonly understood. A statute that adopts a common law term without defining it is construed to adopt the common law meaning. *Neder v. United States*, 527 U.S. 1, 23 (1999); *Gilbert v. United States*, 370 U.S. 650, 655 (1962). The well-established mental states required for fraud, embezzlement, or larceny entail a showing of willfulness or the equivalent: specific intent to defraud, to fraudulently convert, or to steal. Consistent with these *mens rea* requirements, mistake of law was a defense to larceny and embezzlement at common law and it generally remains so today, because a mistake of law precludes a finding of the

required mental state. WAYNE R. LAFAVE, *CRIMINAL LAW* § 19.5 at 944, § 19.6 at 955 (4th ed. 2003); see *State v. Papandrea*, 991 A.2d 617, 623 (Conn. App. Ct. 2010) (larceny) (citing *State v. McRae*, 983 A.2d 286, 290 (Conn. App. Ct. 2009)).

Defalcation was not a term used to describe a common law crime,<sup>4</sup> but there is no reason why a trustee's *bona fide* mistake of law should not be similarly relevant to consideration of whether his breach of fiduciary duty warrants denial of a bankruptcy discharge for a resulting debt. To slam the door on such evidence, by characterizing conduct as "objectively unreasonable" without further inquiry, not only disassociates defalcation from the other offenses in the same sentence of paragraph (a)(4) but also affords too little weight to the fresh start policy. No substantial countervailing concerns are apparent. Taking into consideration evidence of a debtor's lack of knowledge that he was violating the law would not require the bankruptcy court to credit fanciful claims or adopt unreasonable conclusions.<sup>5</sup> See *Cheek*, 498

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<sup>4</sup> As the Aaron amici point out, the term's origin in bankruptcy law may have been a response to an 1838 scandal that certainly involved knowing wrongdoing by Samuel Swartwout. (Aaron Br. 10–11.) See MARK GROSSMAN, *POLITICAL CORRUPTION IN AMERICA: AN ENCYCLOPEDIA OF SCANDALS, POWER, AND GREED* 315 (2003).

<sup>5</sup> The bankruptcy court acts as factfinder in discharge exception cases. *Am. Express Travel Related Servs. Co. v. Hashemi (In re Hashemi)*, 104 F.3d 1122, 1124–25 (9th Cir. 1996) (holding that dischargeability actions are equitable in nature and thus debtor had no constitutional right to jury trial); *In re Maurice*,  
(Continued on following page)



U.S. at 203–04 (“Of course, the more unreasonable the asserted beliefs or misunderstandings are, the more likely the jury will consider them to be nothing more than simple disagreement with known legal duties imposed by the tax laws and will find that the government has carried its burden of proving knowledge.”).

In sum, whatever the requisite mental state is for defalcation, the debtor should be allowed to demonstrate at a trial that, because of a good faith mistake of law, he did not act with it.

### **B. Not Every Breach of Fiduciary Duty Is a “Defalcation.”**

The Aaron *amici* argue that any breach of fiduciary duty under state law is a defalcation under bankruptcy law. (Aaron Br. 8, 16.) The first sign of trouble for this argument is its threshold concession that no federal circuit has adopted this approach (*id.* at 2), though the *amici* chide those courts for failing to provide “meaningful guidance to the lower courts” or “any analytical basis for their varied holdings.” (*Id.* at 1.) In fact, courts have roundly rejected the idea that every state law breach of fiduciary duty is a defalcation, in decisions with analysis aplenty. *E.g.*,

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21 F.3d 767, 773 (7th Cir. 1994) (debtor not entitled to jury trial in dischargeability case).



*Patel v. Shamrock Floorcovering Servs., Inc. (In re Patel)*, 565 F.3d 963, 970 (6th Cir. 2009); *Rutanen ex rel. Quevillon v. Baylis (In re Baylis)*, 313 F.3d 9, 18 (1st Cir. 2002); *Meyer v. Rigdon*, 36 F.3d 1375, 1384–85 (7th Cir. 1994). The *amicus* brief of the United States also disclaims this argument. (U.S. Br. 29 n.18.) Another early sign of trouble is that the *amici* are compelled almost immediately to launch into an unconvincing explanation of why corporate officers and directors must be exempted from the sweeping breadth of their proposed standard. (Aaron Br. 11 n.5.)

But the central failing of the Aaron *amici*'s standard soon becomes plain enough: it would entirely cede to non-bankruptcy law (usually state law) the responsibility for administering an exception to the availability of federal bankruptcy discharge. That has not been the Court's approach for more than a century in construing what is now paragraph (a)(4); time and again, the Court has refused to allow state law notions of what defines a trust to be conclusive in interpreting the defalcation exception. (P. Br. 11–15.) Dischargeability instead is a matter of federal law governed by the terms of the Bankruptcy Code. *Grogan v. Garner*, 498 U.S. 279, 284 (1991). The Aaron *amici* never explain why the "subjective judgments" of state courts are to be preferred over those of federal courts when it comes to applying federal bankruptcy law. (Aaron Br. 9.) Requiring a uniform standard for determining exceptions from discharge is more consistent with the "uniform" bankruptcy law

that is authorized by the Constitution. U.S. Const. art. I, § 8, cl. 4.

There is also the intent of Congress as reflected in the text and history of the provision. The *amici* never explain why Congress did not expressly provide that every debt resulting from a breach of fiduciary duty would be non-dischargeable in bankruptcy, despite many opportunities to do so in any of the several comprehensive revisions of the bankruptcy act over the span of more than a century. By the time of the enactment of 1978's complete overhaul of bankruptcy law, it was clear that courts were not construing "defalcation" to be established whenever there was a breach of fiduciary duty. Nonetheless, Congress retained "defalcation" instead of substituting "breach of fiduciary duty," and has not disturbed that choice in several subsequent revisions, including the extensive Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Pub. L. No. 109-8, 119 Stat. 23 (Apr. 20, 2005).

### **C. Not Every Instance of Self-Dealing Is a "Defalcation."**

For its part, respondent argues that whatever is characterized as self-dealing under non-bankruptcy law automatically constitutes bankruptcy defalcation, under any of the standards applied by the circuits, and that any resulting monetary remedy is a non-dischargeable debt. Like the Aaron *amici*'s standard,

this is overbroad and cedes too much domain over federal bankruptcy discharge to state law.

Respondent's argument overlooks the wide variety of technical trust infractions that can be the product of unintentional or good faith mistakes yet still constitute fiduciary self-dealing under trust law, especially in family-related trusts. For example, a trustee might overcompensate herself based on an honest misreading of the trust instrument; should the resulting debt be *per se* non-dischargeable? A trustee might engage in a transaction on fair terms with a related company without realizing any impropriety, but face a legal challenge later; should a judgment for disgorgement of any profits always be an insolvent trustee's lifetime obligation? Should a trustee who purchases trust property as the highest bidder at a public auction, under the honest belief that she was acting properly, be denied a discharge? Here, transactions to which the beneficiaries might have consented were adjudged, more than a decade after the fact, to be prohibited self-dealing because the petitioner failed to obtain their consents. Debts arising from ruinous but honest mistakes, however, have seldom been regarded as ineligible for discharge in bankruptcy, which is calibrated to provide relief for the "honest but unfortunate debtor." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

Respondent and its *amici* frequently quote stern admonitions from trust *liability* cases such as *Mosser v. Darrow*, 341 U.S. 267 (1951), and imply that trust law liability means that bankruptcy defalcation is

established. (*E.g.*, U.S. Br. 24, 28.) The United States concedes, however, that not every breach of fiduciary duty necessarily constitutes a defalcation. (*Id.* at 29 n.18.) The potential liabilities of modern fiduciaries alone are sufficiently draconian to dissuade wrongdoers, without the overkill of categorical denial of bankruptcy discharge whenever such liabilities arise, regardless of extenuating circumstances. Liability should not be confused with dischargeability.

Respondent points out that the First Circuit's opinion in *Baylis*, 313 F.3d at 20–21, states that defalcation may be presumed from a breach of the duty of loyalty (R. Br. 9–10), but that presumption should be rebuttable in an appropriate case. *Baylis* presented entirely different facts. The trustee in *Baylis* was a lawyer, and there evidently was no contention that he was unaware of the illegality of paying his personal expenses from the trust. Here, petitioner has shown, without contradiction, that he had no knowledge of any legal problem with following his parents' wishes with respect to the three loans. That showing and the other evidence should have been enough to earn him at least a trial, so that he could make his case for discharge, and the Eleventh Circuit erred in affirming the summary judgment for the plaintiff-respondent. Petitioner has no quarrel with a presumption of defalcation arising where there has been a loss to the trust *res* as a result of self-dealing, so long as a debtor can rebut the presumption with evidence that he acted neither in conscious disregard of the law nor with extreme recklessness.

**D. The Statutory Text, Context, and History Indicate That a Culpable Mental State Is Required to Establish Defalcation.**

In his opening brief, petitioner argued that requiring scienter for bankruptcy defalcation is faithful to the statutory text, structure, and purpose. (P. Br. 21.) As with fraud, embezzlement, and larceny, dishonesty is the touchstone of defalcation. In its *amicus* brief, the United States never affirmatively offers a comprehensive definition of defalcation, but does argue that no scienter requirement exists “at least in the context of a self-dealing and unauthorized diversion of trust assets.” (U.S. Br. 17.) A premise for this argument’s applying here is that a court found the three loans to be “unauthorized” (a term that appears at least 17 times in the government’s brief) but, strictly speaking, this is incorrect. The Illinois court denied respondent’s motion for summary judgment on whether the loans were authorized by the trust instrument. The issue was never decided because of the court’s additional ruling that the loans, even if permitted investments, were nevertheless unlawful self-dealing. Pet. App. 53a, 54a. The government urges that its proposed rule be applied in any case in which trust assets are diverted to a use that is ultimately held to be unauthorized (U.S. Br. 20), but no court has so held here.

Putting aside the facts of petitioner’s case, the government’s appeals to dictionary definitions, statutory context, and historical practice are unpersuasive.



**1. Contradictory dictionary definitions supply no answers.**

In his main brief, petitioner pointed out that contemporary dictionary definitions are contradictory and offer little guidance on the meaning of “defalcation” (P. Br. 21), a point also made by petitioner’s *amicus* (Brunstad Br. 19) and apparently not disputed by respondent. The United States nonetheless argues that dictionary definitions of “defalcation” do not require intentional wrongdoing, but its own catalogue of those definitions only serves to establish petitioner’s point. Those definitions include frequent references to “fraudulent” or “fraud” and “embezzlement” and “misappropriation.” (U.S. Br. 10–11.) The United States winds up its discussion of dictionaries with an unconvincing assertion that defalcation “generally” does not require “a showing of intentional wrongdoing” (*id.* at 12), but the only conclusion that can fairly be drawn from its own survey of the contradictory definitions is that they are inconclusive on the required mental state.

**2. The government’s statutory context argument is overextended.**

The United States also argues that the statutory context counsels against requiring a “heightened mental state,” citing paragraph (a)(6), which requires “willful and malicious injury,” and other paragraphs that expressly require willfulness as well. (U.S. Br. 12–13.) The United States concludes from these references that, since paragraph (a)(4) includes no



mention of the mental states, none is required. But, as pointed out above, this argument is clearly overextended. These common law terms—fraud, embezzlement, larceny—carry their common law meanings, which include mental states. See *Morissette v. United States*, 342 U.S. 246, 250 (1952). In paragraph (a)(6), a provision not added until the Bankruptcy Act of 1898, the modifiers “willful” and “malicious” were necessary to make clear that negligent or reckless torts were not excepted from discharge. See *Geiger*, 523 U.S. at 64.

**3. Applying *noscitur a sociis* as petitioner urges would have no undesirable collateral consequences.**

In response to petitioner’s argument that *noscitur a sociis* links defalcation with the nearby statutory terms “fraud,” “embezzlement,” and “larceny,” the United States contends that application of this contextual canon would spell trouble for interpretation of the securities-law discharge exception found in 11 U.S.C. § 523(a)(19). (U.S. Br. 14.) But this is a false dilemma. The government cites no cases exhibiting the confusion it fears. The language of paragraph (a)(19) is unambiguous as to the specified non-dischargeable offenses. “The preeminent canon of statutory interpretation” requires the Court to “‘presume that [the] legislature says in a statute what it means and means in a statute what it says there.’ . . . Thus, our inquiry begins with the statutory text, and ends there as well if the text is unambiguous.”

*BedRoc Ltd., LLC v. United States*, 541 U.S. 176, 183 (2004) (quoting *Conn. Nat'l Bank v. Germain*, 503 U.S. 249, 253–54 (1992)) (alteration in original). No resort to contextual canons is required.

#### **4. The anti-surplusage canon would not be violated.**

The argument of respondent's *amici* that petitioner's argument would deprive "defalcation" of any independent role in the statute is addressed in *Denton v. Hyman (In re Hyman)*, 502 F.3d 61 (2d Cir. 2007) and in *Baylis*, as the United States acknowledges. (U.S. Br. 15–16.) As *Hyman* explained, the requirement of a showing of conscious misbehavior or extreme recklessness "ensures that the term 'defalcation' complements but does not dilute the other terms of the provision—'fraud,' 'embezzlement,' and 'larceny'—all of which require a showing of actual wrongful intent." 502 F.3d at 68.

Respondent and its *amici* liberally cite *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937), but Judge Hand's "carefully equivocal opinion," *Baylis*, 313 F.3d at 18, is regarded by the Second Circuit itself as "wrestl[ing] with this problem without resolving it." *Hyman*, 502 F.3d at 67. The holding in *Herbst*, in which the fiduciary was a court-appointed receiver, is quite limited: "All we decide is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a 'defalcation' though

it may not be a ‘fraud,’ or an ‘embezzlement’ or perhaps not even a ‘misappropriation.’” 93 F.2d at 512. As petitioner’s *amicus* details, *Herbst*’s analysis is flawed (Brunstad Br. 29–30) and the case now mostly serves to illustrate the struggles courts have had in interpreting “defalcation.”

### **5. The government’s historical-practice argument is unenlightening.**

The United States suggests that ambiguity in the statute can be resolved by reference to “historical practice.” (U.S. Br. 17.) But the discussion that follows this suggestion sheds no light on the meaning of defalcation. The United States points out that bankruptcy discharge was unavailable in the 1841 Act to “any person who, after the passing of this act, shall apply trust funds to his own use,” but concedes that the term “defalcation” itself was actually used elsewhere in the statute. (*Id.*) Moreover, the “apply trust funds to his own use” language disappeared from the statute when the 1841 Act was repealed in 1843. Ch. 82, 5 Stat. 614 (1843). The concept resurfaced, perhaps, in the 1898 Act, which for the first time added “misappropriation” to the list of discharge-excepted acts. (P. Br. 13.) Misappropriation is commonly defined as “[t]he application of another’s property or money dishonestly to one’s own use.” BLACK’S LAW DICTIONARY 1088 (9th ed. 2009). Yet “misappropriation” itself was deleted from the 1978 Act. In short, the government’s historical-practice argument is off

the mark because history headed in a different direction.

## II. The Fresh Start Policy Is Embodied in the *Gleason* Rule and Reinforced by the Rule of Lenity.

The Court has held that discharge exceptions are to be “confined to those plainly expressed,” *Gleason v. Thaw*, 236 U.S. 558, 562 (1915), a principle that safeguards bankruptcy’s “fresh start” policy as it applies to exceptions to discharge. No serious argument can be made that “defalcation” has a plain meaning that is dispositive here. The contextual guidance supplied by *noscitur a sociis*, however, parallels the application of the rule of lenity, which has been invoked in civil contexts as well as in criminal cases: “Ambiguity in a statute defining a crime or imposing a penalty should be resolved in the defendant’s favor.” ANTONIN SCALIA & BRYAN A. GARNER, *READING LAW: THE INTERPRETATION OF LEGAL TEXTS* § 49 at 296 (2012); see *Crandon v. United States*, 494 U.S. 152, 158 (1990) (applying rule in civil context). The rule is applicable when reasonable doubt of a term’s meaning still persists after available tools of interpretation have been applied. *Moskal v. United States*, 498 U.S. 103, 108 (1990). Excepting a debt from discharge in bankruptcy is arguably worse than a civil penalty; where the debt is substantial it is a sentence of permanent insolvency. Applying the rule of lenity to resolve uncertainties in the scope of exceptions to discharge would reinforce the “fresh start” policy embodied in

the *Gleason* principle. "On the whole, it might fairly be said that the rule of lenity is underused in modern judicial decision-making—perhaps the consequence of zeal to smite the wicked." SCALIA & GARNER at 301 (footnote omitted). Overzealousness is in abundant supply here, but wickedness is absent. The only court to hear testimony could find no malicious intent by petitioner. No finding has been made that he acted dishonestly. The profits-recovery judgment against him should have been ruled dischargeable because there was no evidence that he acted with a culpable mental state. At the very least, he was entitled to a trial on the dischargeability of that debt.

### **III. Failure to Produce the Entrusted Property Is Required for "Defalcation."**

Assuming a culpable mental state is established, the issue is what *act* is required to commit a bankruptcy defalcation. Petitioner argued in his main brief that a failure to produce the funds entrusted to the fiduciary is a requirement for a "defalcation," as understood when the term was first introduced, in the 1841 Bankruptcy Act. (P. Br. 26.)

Respondent counters that "[b]y making self-dealing loans Bullock committed defalcation by misappropriation of the Trust corpus." (R. Br. 21.) But this argument overlooks the deletion of "misappropriation" from the current statute in 1978. The United States acknowledges that deletion but suggests that it was solely attributable to a desire to eliminate



redundancy. (U.S. Br. 22.) That suggestion, however, presumes a pre-repeal redundancy and thus collides with the anti-surplusage canon. A more plausible inference is that Congress did not intend that every minor misappropriation be regarded as a defalcation that results in a bar to discharge of any resulting debt. An act of "misappropriation" is not necessarily a defalcation; something more is required, some real harm or loss.

Respondent and its *amici* argue that a trustee's failure to send annual reports to beneficiaries where required, as the court here found, is itself the sort of misconduct that should constitute defalcation and deny the errant trustee a discharge of any associated debt. (R. Br. 21.) But they cite no support in the case law for this harsh result. Here, in any event, the supposed profits that were the subject of the judgment were attributed to the three loans, not the failure to tender reports. And no one could seriously argue that a trustee's failure to provide reports that did not result either in a loss to the trust or in profits to the trustee could be a basis for bankruptcy defalcation.

The United States points out that a person who commits fraud, embezzlement, or larceny does not necessarily escape criminal liability by returning the property. (U.S. Br. 24-26 & n.16.) But the United States cites no case in which a bankruptcy discharge of a debt has been denied for someone found to have committed one of those offenses where all of the property was returned before legal action. Such return



tends to negate the mental state required to find fraud, embezzlement, or larceny, as well as eliminate any loss. *See Consumer United Ins. Co. v. Bustamante (In re Bustamante)*, 239 B.R. 770, 777 (Bankr. N.D. Ohio 1999); *C & J Rentals, Inc. v. Purdy (In re Purdy)*, 231 B.R. 310, 312–13 (Bankr. E.D. Mo. 1999).

The question here is whether the conduct underlying the judgment for disgorgement of profits, essentially a penalty, plus attorneys' fees incurred in obtaining that judgment, qualifies as defalcation. Respondent refers several times to petitioner's "harm [to] the Trust" (R. Br. 3), but cites nothing in the record establishing any actual harm to the trust. The life insurance policy retained the same value at the conclusion of petitioner's tenure as trustee that it had when he (unwittingly) began his service. The loans that were made to his mother and himself were repaid, with interest.

Notably, any of the estimated profits that resulted from the loans were presumably captured by the broad constructive trust imposed by the Illinois court, which installed respondent as trustee of that trust. Specifically, the court found that the Springfield, Ohio mill was the "first property acquired through the wrongful use of trust property" and imposed a constructive trust on the mill. Pet. App. 47a. The court also imposed a constructive trust on the assets of petitioner, including real estate, and on the two family-related companies that conceivably could have benefited from the loans. *Id.* Consequently, the profits that petitioner could have received were

subject to the constructive trust—of which respondent was the trustee. Yet respondent did nothing in the ensuing years to apply any of those assets to the judgment. Respondent is incorrect that petitioner's evidence of respondent's failure to sell some of the assets despite his repeated requests has "never been put in evidence in the record in this case." (R. Br. 2 n.1.) Petitioner's *pro se* opposition to summary judgment, received in the bankruptcy court without objection by respondent, chronicles respondent's multiple failures to act to protect the trust and permit him to pay the judgment by liquidating the constructive trust's assets before they deteriorated in value. The district court took note of such evidence, and lambasted respondent's "abusing its position of trust by failing to liquidate the assets." Pet. App. 27a. Not only was there no loss of trust *res*, but there could have been recovery of the disgorged benefits if respondent had acted responsibly.

At the very least, the absence of any loss of trust *res* or any showing of any risk of such loss should be relevant to a determination of whether petitioner acted with a mental state sufficiently culpable to warrant excepting the judgment against him from discharge.

---

## CONCLUSION

Petitioner suffered summary judgment on respondent's claim that his debt should be excepted

from discharge, but neither his actions nor his accompanying mental state amounts to the sort of intentional misconduct that would warrant exclusion from discharge. At a minimum, the state court's "self-dealing" finding, by itself, was insufficient to deprive him of his right to a trial on the issues. The Eleventh Circuit's judgment should be vacated and the case remanded for further proceedings consistent with the Court's opinion.

Respectfully submitted,

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February 11, 2013

**AMICUS  
CURIAE  
BRIEF**

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**In the Supreme Court of the United States**

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**RANDY CURTIS BULLOCK, PETITIONER**

**v.**

**BANKCHAMPAIGN, N.A.**

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**ON WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE ELEVENTH CIRCUIT**

---

**BRIEF FOR THE UNITED STATES  
AS AMICUS CURIAE SUPPORTING RESPONDENT**

---

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### QUESTION PRESENTED

Section 523(a)(4) of the Bankruptcy Code provides that "[a] discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt \* \* \* for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." 11 U.S.C. 523(a)(4). The question presented is as follows:

Whether a trustee's unauthorized and self-dealing diversion of funds from a trust constitutes a "defalcation" for purposes of 11 U.S.C. 523(a)(4) in the absence of any specific finding of ill intent or evidence of an ultimate loss of trust principal.





## TABLE OF CONTENTS

|                                                                                                                                                                                                 | Page |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| Interest of the United States .....                                                                                                                                                             | 1    |
| Statutory provision involved .....                                                                                                                                                              | 2    |
| Statement.....                                                                                                                                                                                  | 2    |
| Summary of argument .....                                                                                                                                                                       | 6    |
| <b>Argument:</b>                                                                                                                                                                                |      |
| A trustee's unauthorized and self-dealing diversion<br>of trust assets constitutes a "defalcation while acting<br>in a fiduciary capacity" for purposes of 11 U.S.C.<br>523(a)(4) .....         | 8    |
| A. The statutory text, context, and history do not<br>make proof of a heightened mental state a<br>prerequisite to a "defalcation" .....                                                        | 9    |
| 1. Dictionary definitions of "defalcation"<br>do not require intentional wrongdoing.....                                                                                                        | 10   |
| 2. The statutory context counsels against<br>requiring a heightened mental state.....                                                                                                           | 12   |
| 3. Historical practice supports treating a<br>trustee's unauthorized and self-dealing<br>diversion of trust assets as a "defalcation" .....                                                     | 17   |
| B. Even in the absence of any ultimate loss<br>of the trust principal, a trustee's diversion<br>of trust assets to his own benefit may be a<br>"defalcation" .....                              | 21   |
| C. The policy interests underlying Section 523(a)(4)<br>are served by refusing to discharge debts resulting<br>from a trustee's unauthorized and<br>self-dealing diversion of trust assets..... | 27   |
| D. Petitioner's conduct constituted a "defalcation<br>while acting in a fiduciary capacity".....                                                                                                | 30   |
| Conclusion.....                                                                                                                                                                                 | 33   |
| Appendix .....                                                                                                                                                                                  | 1a   |

## IV

### TABLE OF AUTHORITIES

| Cases:                                                                                              | Page           |
|-----------------------------------------------------------------------------------------------------|----------------|
| <i>Baylis, In re</i> , 313 F.3d 9 (1st Cir. 2002).....                                              | 16, 31         |
| <i>Bruning v. United States</i> , 376 U.S. 358 (1964) .....                                         | 27             |
| <i>Central Hanover Bank &amp; Trust Co. v. Herbst</i> ,<br>93 F.2d 510 (2d Cir. 1937).....          | 15, 20, 21, 31 |
| <i>Chapman v. Forsyth</i> , 43 U.S. (2 How.) 202<br>(1844).....                                     | 18             |
| <i>Cohen v. de la Cruz</i> , 523 U.S. 213 (1998) .....                                              | 27             |
| <i>Crawford v. Burke</i> , 195 U.S. 176 (1904) .....                                                | 18             |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328<br>(1934).....                                  | 13, 19, 20     |
| <i>Denton v. Hyman</i> , 555 U.S. 1097 (2009).....                                                  | 1              |
| <i>Duncan v. Walker</i> , 533 U.S. 167 (2001) .....                                                 | 15             |
| <i>Elmore v. United States</i> , 267 F.2d 595 (4th Cir.),<br>cert. denied, 361 U.S. 832 (1959)..... | 26             |
| <i>Freeman v. Quicken Loans, Inc.</i> , 132 S. Ct. 2034<br>(2012).....                              | 12             |
| <i>Gott, In re</i> , 387 B.R. 17 (Bankr. S.D. Iowa 2008) .....                                      | 2              |
| <i>Grogan v. Garner</i> , 498 U.S. 279 (1991) .....                                                 | 27, 32         |
| <i>Hammond, In re</i> , 98 F.2d 703 (2d Cir.),<br>cert. denied, 305 U.S. 646 (1938).....            | 21             |
| <i>Hemmeter, In re</i> , 242 F.3d 1186 (9th Cir. 2001).....                                         | 29             |
| <i>Hyman, In re</i> , 502 F.3d 61 (2d Cir. 2007), cert.<br>denied, 555 U.S. 1097 (2009).....        | 15             |
| <i>Jama v. ICE</i> , 543 U.S. 335 (2005).....                                                       | 13             |
| <i>Johnson, In re</i> , 691 F.2d 249 (6th Cir. 1982) .....                                          | 29             |
| <i>Keime v. Graff</i> , 14 F. Cas. 218 (W.D. Pa. 1878)<br>(No. 7650).....                           | 19             |
| <i>Leigh v. Engle</i> , 727 F.2d 113 (7th Cir. 1984) .....                                          | 24             |
| <i>Local Loan Co. v. Hunt</i> , 292 U.S. 234 (1934) .....                                           | 27, 29         |

# V

| Cases—Continued:                                                                                                                                                    | Page           |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------|
| <i>Meinhard v. Salmon</i> , 164 N.E. 545 (N.Y. 1928).....                                                                                                           | 28             |
| <i>Mosser v. Darrow</i> , 341 U.S. 267 (1951).....                                                                                                                  | 24, 28, 31, 32 |
| <i>Neal v. Clark</i> , 95 U.S. 704 (1878).....                                                                                                                      | 18             |
| <i>NLRB v. Amaz Coal Co.</i> , 453 U.S. 322 (1981).....                                                                                                             | 28             |
| <i>Palombo, In re</i> , 456 B.R. 48 (Bankr. C.D. Cal. 2011) .....                                                                                                   | 2              |
| <i>Patel, In re</i> , 565 F.3d 963 (6th Cir. 2009).....                                                                                                             | 28             |
| <i>Pegram v. Herdrich</i> , 530 U.S. 211 (2000) .....                                                                                                               | 23             |
| <i>RadLAX Gateway Hotel, LLC v. Amalgamated Bank</i> , 132 S. Ct. 2065 (2012).....                                                                                  | 17             |
| <i>Rakes v. United States</i> , 169 F.2d 739 (4th Cir.), cert. denied, 335 U.S. 826 (1948).....                                                                     | 25             |
| <i>Richardson, In re</i> , 178 B.R. 19 (Bankr. D.D.C.), aff'd, 193 B.R. 378 (D.D.C. 1995), aff'd, 107 F.3d 923 (D.C. Cir.), cert. denied, 522 U.S. 851 (1997) ..... | 31             |
| <i>SEC v. Moran</i> , 944 F. Supp. 286 (S.D.N.Y. 1996).....                                                                                                         | 15             |
| <i>United States v. Bailey</i> , 734 F.2d 296 (7th Cir.), cert. denied, 469 U.S. 931 (1984).....                                                                    | 25             |
| <i>United States v. Collins</i> , 464 F.2d 1163 (9th Cir. 1972) .....                                                                                               | 25             |
| <i>United States v. Milton</i> , 8 F.3d 39 (D.C. Cir. 1993), cert. denied, 513 U.S. 919 (1994).....                                                                 | 25             |
| <i>United States v. Sotelo</i> , 436 U.S. 268 (1978).....                                                                                                           | 27             |

## Statutes:

|                                                       |                |
|-------------------------------------------------------|----------------|
| Act of Aug. 19, 1841, ch. 9, 5 Stat. 440:             |                |
| § 1, 5 Stat. 441 .....                                | 9, 17, 18      |
| § 4, 5 Stat. 443-444 .....                            | 17, 18, 28, 29 |
| Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533..... | 10             |
| Act of July 1, 1898, ch. 541, 30 Stat. 544:           |                |
| § 17(2), 30 Stat. 550 (11 U.S.C. 35(2) (1925)) .....  | 19             |

## VI

| Statutes—Continued:                                      | Page             |
|----------------------------------------------------------|------------------|
| § 17(4), 30 Stat. 550-551 (11 U.S.C. 35(4) (1925)) ..... | 10, 19, 20       |
| <b>Bankruptcy Code, 11 U.S.C. 101 <i>et seq.</i>:</b>    |                  |
| 11 U.S.C. 307.....                                       | 1                |
| 11 U.S.C. 523.....                                       | 2                |
| 11 U.S.C. 523(a).....                                    | 6, 7, 12, 27, 28 |
| 11 U.S.C. 523(a)(1)(C).....                              | 13               |
| 11 U.S.C. 523(a)(2)(A).....                              | 18, 27           |
| 11 U.S.C. 523(a)(2)(B)(iv).....                          | 13               |
| 11 U.S.C. 523(a)(4) .....                                | <i>passim</i>    |
| 11 U.S.C. 523(a)(6) .....                                | 12, 19           |
| 11 U.S.C. 523(a)(11) .....                               | 9                |
| 11 U.S.C. 523(a)(12) .....                               | 13               |
| 11 U.S.C. 523(a)(19) .....                               | 14, 15           |
| 11 U.S.C. 523(a)(19)(A)(i).....                          | 14               |
| 11 U.S.C. 523(a)(19)(A)(ii).....                         | 14               |
| 11 U.S.C. 523(a)(19)(B)(iii).....                        | 14               |
| <b>Comprehensive Crime Control Act of 1990,</b>          |                  |
| Pub. L. No. 101-647, § 2522(a)(1), 104 Stat. 4866 .....  | 9                |
| <b>Employee Retirement Income and Security Act of</b>    |                  |
| 1974, 29 U.S.C. 1001 <i>et seq.</i> .....                | 2                |
| 15 U.S.C. 78u(d)(3)(B)(i).....                           | 14               |
| 15 U.S.C. 78u(d)(3)(B)(ii) .....                         | 14               |
| 15 U.S.C. 78u(d)(3)(B)(iii) .....                        | 14               |
| 18 U.S.C. 641 .....                                      | 25               |
| 18 U.S.C. 656 .....                                      | 25               |
| 28 U.S.C. 581-589a (2006 & Supp. V 2011).....            | 1                |
| <b>Miscellaneous:</b>                                    |                  |
| <i>American Heritage Dictionary</i> (4th ed. 2006).....  | 11               |

## VII

| Miscellaneous—Continued:                                                                                                                       | Page       |
|------------------------------------------------------------------------------------------------------------------------------------------------|------------|
| <b>Henry Campbell Black, <i>A Law Dictionary</i>:</b>                                                                                          |            |
| (1891).....                                                                                                                                    | 11         |
| (2d ed. 1910) .....                                                                                                                            | 11         |
| <b><i>Black's Law Dictionary</i>:</b>                                                                                                          |            |
| (5th ed. 1979).....                                                                                                                            | 11         |
| (9th ed. 2009).....                                                                                                                            | 11         |
| 1 John Bouvier, <i>A Law Dictionary</i> (6th ed. 1856) .....                                                                                   | 12         |
| 124 Cong. Rec. 32,399 (1978).....                                                                                                              | 19         |
| <b>Bryan A. Garner, <i>Garner's Modern American Usage</i> (3d ed. 2009) .....</b>                                                              |            |
|                                                                                                                                                | 11         |
| <b>H.R. Rep. No. 595, 95th Cong., 1st Sess.</b>                                                                                                |            |
| (1977).....                                                                                                                                    | 16, 17, 22 |
| 1 Samuel Johnson, <i>A Dictionary of the English Language</i> (1755).....                                                                      | 22         |
| 3 Wayne R. LaFave, <i>Substantive Criminal Law</i> (2d ed. 2003).....                                                                          | 25, 26     |
| <b><i>Oxford English Dictionary</i>:</b>                                                                                                       |            |
| Vol. 3 (1933).....                                                                                                                             | 10         |
| Vol. 4 (2d ed. 1989) .....                                                                                                                     | 10, 22     |
| <b><i>Report of the Commission on the Bankruptcy Laws of the United States</i>, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. 2 (1973) .....</b> |            |
|                                                                                                                                                | 16         |
| <b>Restatement (Third) of Trusts:</b>                                                                                                          |            |
| Vol. 3 (2005).....                                                                                                                             | 23         |
| Vol. 4 (2011).....                                                                                                                             | 24         |
| S. Rep. No. 989, 95th Cong., 2d Sess. (1978) .....                                                                                             | 16         |
| <b>2A Austin W. Scott &amp; William F. Fratcher, <i>The Law of Trusts</i> (4th ed. 1987) .....</b>                                             |            |
|                                                                                                                                                | 23         |
| <b>Noah Webster, <i>An American Dictionary of the English Language</i> (1828) .....</b>                                                        |            |
|                                                                                                                                                | 22         |



## VIII

| Miscellaneous—Continued:                                            | Page |
|---------------------------------------------------------------------|------|
| <i>Webster's New International Dictionary</i><br>(2d ed. 1958)..... | 11   |
| <i>Webster's Third New International Dictionary</i><br>(1986).....  | 11   |

# **In the Supreme Court of the United States**

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No. 11-1518

**RANDY CURTIS BULLOCK, PETITIONER**

**v.**

**BANKCHAMPAIGN, N.A.**

---

**ON WRIT OF CERTIORARI  
TO THE UNITED STATES COURT OF APPEALS  
FOR THE ELEVENTH CIRCUIT**

---

**BRIEF FOR THE UNITED STATES  
AS AMICUS CURIAE SUPPORTING RESPONDENT**

---

## **INTEREST OF THE UNITED STATES**

The question presented in this case is whether, in the absence of any specific finding of ill intent or evidence of an ultimate loss of trust principal, a trustee's unauthorized and self-dealing diversion of funds from a trust constitutes a "defalcation" for purposes of 11 U.S.C. 523(a)(4).<sup>1</sup> The United States has a substantial interest in the resolution of the question presented because United States Trustees—who are Department of Justice officials appointed by the Attorney General—supervise the administration of bankruptcy cases. See 28 U.S.C. 581-589a (2006 & Supp. V 2011); see also 11 U.S.C. 307 ("The United States trustee

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<sup>1</sup> In *Denton v. Hyman*, No. 07-952, the United States filed an amicus curiae brief at the Court's invitation to address a similar question. The Court denied certiorari. 555 U.S. 1097 (2009).

may raise and may appear and be heard on any issue in any [bankruptcy] case or proceeding.”). In addition, the Secretary of Labor, who is responsible for enforcing Title I of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.*, including ERISA’s fiduciary standards, has litigated the scope of the “defalcation” exception to dischargeability in bankruptcy cases involving fiduciaries’ use of plan assets for unauthorized purposes or failure to deposit employee contributions.<sup>2</sup>

#### STATUTORY PROVISION INVOLVED

Pertinent portions of 11 U.S.C. 523 are reprinted in an appendix to this brief. App., *infra*, 1a-4a.

#### STATEMENT

1. In 1978, petitioner’s father established a trust with his life-insurance policy as the sole asset. Pet. App. 2a. The father named petitioner and petitioner’s four siblings as beneficiaries, and he made petitioner the trustee. *Ibid.* Under the terms of the trust, petitioner could borrow from the trust only to pay the life-insurance premiums or to satisfy a beneficiary’s request for a withdrawal. *Ibid.*

On three occasions, petitioner borrowed from the trust for other purposes: (1) in 1981, at his father’s request, he borrowed \$117,545.96 for his mother to

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<sup>2</sup> See, e.g., *In re Palombo*, 456 B.R. 48, 65 (Bankr. C.D. Cal. 2011) (finding defalcation where debtor caused fund holding assets of ERISA plans to accept existing claims liability from another fund, while setting imprudently low contribution rates that generated commissions for debtor but were insufficient to pay new claims); *In re Gott*, 387 B.R. 17 (Bankr. S.D. Iowa 2008) (finding defalcation where debtor failed to ensure funds withdrawn from his employees’ paychecks were remitted to plan administrator, instead of being used for company’s day-to-day operations).

use to repay a debt to the father's business; (2) in 1984, he borrowed \$80,257.04 to purchase certificates of deposit for himself and his mother (which they later used to purchase a mill); and (3) in 1990, he borrowed \$66,223.96, which he used to purchase real estate for himself and his mother. Pet. App. 2a. All three loans were ultimately repaid with 6% interest, but the trust did not earn any profit on them. *Id.* at 2a, 17a, 34a, 45a, 50a. In 1999, petitioner's two brothers (both trust beneficiaries) sued petitioner in Illinois state court for breach of fiduciary duty. *Id.* at 2a, 50a-51a.

In 2002, the state court granted partial summary judgment for the brothers. Pet. App. 50a-58a. The court determined that petitioner had breached his fiduciary duty because he "was clearly involved in self-dealing" when he made loans to his mother and to entities in which he had a financial interest. *Id.* at 52a, 54a-57a. The court also found that petitioner had "breached' his fundamental fiduciary duty" by "put-[ting] himself in a position in conflict with the interests of the beneficiaries." *Id.* at 51a, 52a, 57a. The court further found that petitioner had "failed to make an annual accounting of the trust until approximately 1997," and that he had therefore failed to account, as required, for transactions in which "he borrowed money from the life insurance policy and then loaned it out." *Id.* at 58a.

In its order awarding damages, the state court observed that petitioner "does not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a. The court concluded, however, that "neither the facts and circumstances surrounding the loans" nor petitioner's motives for acting as he did "can excuse him from liability" for "a clear breach of

[his] fiduciary duty.” *Id.* at 46a. The court ordered petitioner to pay the trust \$250,000 “to represent the benefits he received from his breaches,” plus \$35,000 in attorney’s fees and costs. *Id.* at 47a. As collateral for the judgment, the court declared a constructive trust on petitioner’s own beneficial interest in the trust and on the mill that had been obtained with borrowed funds. *Id.* at 47a-48a. Those constructive trusts were awarded to respondent, which had already replaced petitioner as trustee for the original trust. *Id.* at 3a, 48a.

2. In 2009, petitioner filed for relief under Chapter 7 of the Bankruptcy Code in the Northern District of Alabama. Pet. App. 30a. Respondent later initiated an adversary proceeding to determine the dischargeability of the debt that petitioner owed as a result of the Illinois judgment. *Ibid.* Under 11 U.S.C. 523(a)(4), the discharge that an individual debtor in bankruptcy might otherwise receive does not extend to any debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.”

The bankruptcy court granted summary judgment in favor of respondent. Pet. App. 29a-44a. Applying principles of collateral estoppel, the bankruptcy court accepted the state court’s determination that petitioner’s self-dealing conduct had breached his fiduciary duties as trustee. *Id.* at 40a. The bankruptcy court found that the state court’s findings of fact and conclusions of law were “clearly sufficient to establish defalcation for purposes of § 523(a)(4),” because petitioner’s conduct “was certainly not unintentional, nor a purely innocent mistake.” *Ibid.* The bankruptcy



court therefore held that the Illinois judgment debt was nondischargeable. *Id.* at 40a-41a, 44a.<sup>3</sup>

3. Petitioner appealed to the district court, which affirmed. Pet. App. 16a-28a. The district court concluded that petitioner's fiduciary breach had constituted a "defalcation" for purposes of Section 523(a)(4). *Id.* at 21a-23a. The court observed that, "[e]ven though [petitioner] repaid the funds, this is not the same as never having taken them out of the trust in the first place," and that "defalcation includes the fiduciary's failure to account for funds due to any breach of duty, whether it was intentional, willful, reckless, or negligent." *Id.* at 22a. The district court further concluded that collateral estoppel precluded petitioner from relitigating the question, previously resolved against him in the state-court proceedings, whether his borrowing of trust assets constituted a breach of his fiduciary duties. *Id.* at 23a-25a.<sup>4</sup>

4. The court of appeals affirmed. Pet. App. 1a-14a. The court recognized that different circuits have expressed inconsistent understandings of the term "defalcation" under Section 523(a)(4). Pet. App. 9a. The court described three circuits as holding that "even an innocent act by a fiduciary can be a defalcation"; three

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<sup>3</sup> In the alternative, the bankruptcy court found that petitioner's breach of fiduciary duty by self-dealing was also "fraud while acting in a fiduciary capacity for purposes of § 523(a)(4)." Pet. App. 41a-42a.

<sup>4</sup> The district court rejected petitioner's affirmative defense that respondent was wrongfully preventing petitioner from using the assets in constructive trust to satisfy the state-court judgment. Pet. App. 25a-27a. Although the court was "convinced" that respondent was "abusing its position of trust by failing to liquidate the assets," it found that petitioner should raise the issue "in an action in Illinois." *Id.* at 27a.



others as “requir[ing] a showing of recklessness by the fiduciary”; and two as “requir[ing] a showing of extreme recklessness.” *Id.* at 9a-10a. The court of appeals concluded that “defalcation requires a known breach of a fiduciary duty, such that the conduct can be characterized as objectively reckless.” *Id.* at 10a-11a.

Applying that standard to the facts of this case, the court of appeals determined that petitioner’s conduct as trustee “can be characterized as objectively reckless” because petitioner “certainly should have known that he was engaging in self-dealing, given that he knowingly benefitted from the loans.” Pet. App. 11a. The court held that “the Illinois judgment debt was non-dischargeable under § 523(a)(4) as a debt arising from a defalcation while [petitioner] was acting in a fiduciary capacity.” *Ibid.*<sup>5</sup>

#### SUMMARY OF ARGUMENT

A. The statutory text, context, and history of 11 U.S.C. 523(a)(4) all indicate that proof of a heightened mental state is not a prerequisite to a “defalcation,” at least where the relevant fiduciary breach is an unauthorized and self-dealing diversion of trust assets. Dictionary definitions of that term do not suggest such a requirement. While other provisions of Section 523(a) specify the mental state needed to trigger other exceptions to dischargeability, Section 523(a)(4) re-

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<sup>5</sup> In light of its finding of a “defalcation,” the court of appeals did not address whether petitioner’s “conduct also constituted fraud under § 523(a)(4).” Pet. App. 7a n.2. The court considered and rejected petitioner’s affirmative defense premised on respondent’s refusal to allow him to liquidate the assets held in constructive trust. *Id.* at 11a-14a. That issue is beyond the scope of the question presented in this Court.

quires only that the debtor have committed defalcation “while acting in a fiduciary capacity.” And while scienter is an element of the accompanying terms “fraud,” “embezzlement,” and “larceny,” that fact does not suggest that “defalcation” should be given anything other than its usual dictionary meaning. Indeed, the term “defalcation” in Section 523(a)(4) would be superfluous if it were read to require the *same* heightened mental state as “fraud,” “embezzlement,” and “larceny.” The drafting history of current Section 523(a)(4), and Congress’s use of the term “defalcation” in prior versions of the bankruptcy laws, reinforce the conclusion that no heightened mental state is required.

B. Proof of ultimate loss of the trust principal is likewise not a prerequisite to a Section 523(a)(4) “defalcation.” Self-dealing with trust assets is a paradigmatic breach of the trustee’s duty of loyalty. Even if the diverted funds are eventually returned to the trust, the trustee still must repay any profits realized as a result of the diversion, and may also be required to reimburse attorney’s fees and other costs incurred by the trust in recouping the assets. Just as repayment of funds would not negate potential liability for fraud, embezzlement, or larceny, it does not negate the existence of a “defalcation.”

C. Petitioner invokes the Bankruptcy Code’s policy of giving a “fresh start” to the “honest but unfortunate debtor.” Section 523(a), however, reflects Congress’s determination that, for specified categories of debts, that policy is overridden by countervailing values. A trustee’s diversion of trust assets to his own use is a particularly serious fiduciary breach. There are sound equitable reasons to deny discharge for

debts incurred as a result of such misconduct, and debts of that nature have historically been nondischargeable.

D. The courts below correctly held that petitioner's debt is nondischargeable under Section 523(a)(4). Petitioner's apparent lack of malice does not excuse his diversion of trust assets, since knowledge of fundamental legal obligations has long been imputed to fiduciaries. The fact that petitioner ultimately repaid the trust principal likewise does not render the debt dischargeable. Notwithstanding that repayment, petitioner committed a serious breach of his fundamental duty of loyalty to the trust; his diversion of assets created a temporary shortage until the loans were repaid; and petitioner never fulfilled his obligation to pay over to the trust the profits he had realized from the diversion.

#### **ARGUMENT**

##### **A TRUSTEE'S UNAUTHORIZED AND SELF-DEALING DIVERSION OF TRUST ASSETS CONSTITUTES A "DEFALCATION WHILE ACTING IN A FIDUCIARY CAPACITY" FOR PURPOSES OF 11 U.S.C. 523(a)(4)**

The debt at issue here resulted from petitioner's unauthorized and self-dealing diversion of trust assets, from which he gained financial reward. Petitioner contends that his conduct did not rise to the level of a "defalcation while acting in a fiduciary capacity" for purposes of nondischargeability under 11 U.S.C. 523(a)(4) because "[t]he state court's finding of no apparent ill intent, coupled with the absence of loss of *res*, falls far short of establishing the sort of grave misconduct" that warrants a denial of discharge in bankruptcy. Pet. Br. 26. That argument lacks merit. Petitioner's diversion of trust assets was a sufficiently

grievous breach of fiduciary duty to constitute a “defalcation,” even without proof that he had a subjective mental state of at least “extreme recklessness” (*id.* at 21), and even without proof of any ultimate “loss of the trust principal” (*id.* at 27).

**A. The Statutory Text, Context, And History Do Not Make Proof Of A Heightened Mental State A Prerequisite To A “Defalcation”**

Section 523 of the Bankruptcy Code provides in pertinent part:

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

\* \* \* \* \*

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny[.]

11 U.S.C. 523(a)(4).<sup>6</sup> The Bankruptcy Code, which was enacted in 1978, does not define the term “defalcation.” But earlier bankruptcy laws—enacted in 1841,<sup>7</sup>

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<sup>6</sup> Section 523(a)(11) excepts from discharge debts created by certain judgments, orders, or settlements “arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union.” 11 U.S.C. 523(a)(11). That provision was added by the Comprehensive Crime Control Act of 1990, Pub. L. No. 101-647, § 2522(a)(1), 104 Stat. 4866.

<sup>7</sup> Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441 (repealed 1843) (making bankruptcy available to “[a]ll persons \* \* \* owing debts, which shall not have been created in consequence of a defalcation as a public officer, or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity”).

1867,<sup>8</sup> and 1898<sup>9</sup>—had each contained similar provisions that, with minor variations of phrasing, generally prevented the discharge of debts arising from “defalcation[s]” in a fiduciary context.

**1. Dictionary definitions of “defalcation” do not require intentional wrongdoing**

Dictionary definitions of “defalcation”—whether current, contemporaneous with the Bankruptcy Code, or contemporaneous with older bankruptcy statutes—do not require any particular mental state, much less the specific intent associated with “fraud” or “embezzlement” that petitioner urges (Br. 21-22) the Court to impose here.

The relevant definition in the *Oxford English Dictionary* reads: “A monetary deficiency through breach of trust by one who has the management or charge of funds; a fraudulent deficiency in money matters[.]” 4 *Oxford English Dictionary* 369 (2d ed. 1989) (*OED*). The first illustrative quotation for that definition is from an 1846 dictionary, which reads: “a breach of trust by one who has charge or management of money.” *Ibid.*; see also 3 *Oxford English Dictionary* 124 (1933) (same). Other modern dictionaries similarly include, sometimes in addition to a reference to fraud or embezzlement, a reference to “misuse” or “misappropriation” of funds that connotes no particu-

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<sup>8</sup> Act of Mar. 2, 1867, ch. 176, § 33, 14 Stat. 533 (repealed 1878) (rendering nondischargeable any “debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character”).

<sup>9</sup> Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-551 (repealed 1979) (rendering nondischargeable any debt “created by [the debtor’s] fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity”).



lar mental state. See *American Heritage Dictionary* 475 (4th ed. 2006) (“To misuse funds; embezzle.”); *Webster’s Third New International Dictionary* 590 (1986) (“misappropriation of money in one’s keeping”); *Webster’s New International Dictionary* 686 (2d ed. 1958) (“An abstraction or misappropriation of money by one, esp. an officer or agent, having it in trust[.]”).

The current edition of *Black’s Law Dictionary* similarly defines “defalcation” in part as follows: “1. EMBEZZLEMENT. 2. Loosely, the failure to meet an obligation; a nonfraudulent default.” *Black’s Law Dictionary* 479 (9th ed. 2009).<sup>10</sup> Earlier editions of the same dictionary, including the one most contemporaneous with the enactment of Section 523(a)(4), repeatedly included the following definitions (and sometimes others): “The act of a defaulter”; “misappropriation of trust funds or money held in any fiduciary capacity”; and “failure to properly account for such funds.” *Black’s Law Dictionary* 375 (5th ed. 1979); Henry Campbell Black, *A Law Dictionary* 342 (2d ed. 1910); Henry Campbell Black, *A Dictionary of Law* 344 (1891). Similarly, an 1856 law dictionary defined a

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<sup>10</sup> The editor in chief of *Black’s Law Dictionary* has elsewhere expressed a preference for the “embezzlement” definition of “defalcation,” while acknowledging that the word has been “misused” by “some writers” to refer “merely to a nonfraudulent default.” Bryan A. Garner, *Garner’s Modern American Usage* 232 (3d ed. 2009). In Garner’s view, the term is more properly limited to a “fraudulent” deficiency that is “the fault of someone put in trust of the money.” *Ibid.* Congress included Garner’s second limitation in Section 523(a)(4), by requiring a defalcation to occur in a fiduciary capacity. The structure of Section 523(a)(4), however, counsels against concluding that Congress intended “defalcation” to be synonymous with “fraud” in a fiduciary capacity or with “embezzlement,” because that would render it surplusage.



“defalcation” in relevant part as “the act of a defaulter.” 1 John Bouvier, *A Law Dictionary* 388 (6th ed. 1856). In turn, it defined a “defaulter” as “[o]ne who is deficient in his accounts, or fails in making his accounts correct.” *Ibid.*

Thus, as a matter of plain meaning, a “defalcation” generally does not require a showing of intentional wrongdoing.

**2. The statutory context counsels against requiring a heightened mental state**

Petitioner contends that, in light of the “statutory context” and “the commonsense canon of *noscitur a sociis*—which counsels that a word is given more precise content by the neighboring words with which it is associated”—the Court should construe “defalcation” to ensure that it reflects a “degree of culpability commensurate with fraud, embezzlement, and larceny.” Br. 21, 23 (quoting *Freeman v. Quicken Loans, Inc.*, 132 S. Ct. 2034, 2042 (2012)). Petitioner therefore contends that the Court should require “a showing of a mental state embracing intent to deceive, manipulate, or defraud, or extreme recklessness.” Br. 23 (internal quotation marks and citation omitted). For several reasons, however, the statutory context weighs against petitioner’s argument rather than in its favor.

a. In other provisions of Section 523(a), Congress specified the mental state associated with the activity that gives rise to a nondischargeable debt. For instance, one provision applies to debts “for willful and malicious injury by the debtor to another entity or to the property of another entity.” 11 U.S.C. 523(a)(6). One refers to a “malicious or reckless failure to fulfill any commitment by the debtor to a Federal deposito-

ry institutions regulatory agency to maintain the capital of an insured depository institution.” 11 U.S.C. 523(a)(12). Another refers to a tax duty “with respect to which the debtor \* \* \* willfully attempted in any matter to evade or defeat such tax.” 11 U.S.C. 523(a)(1)(C). And another refers to using a materially false written statement “that the debtor caused to be made or published with intent to deceive.” 11 U.S.C. 523(a)(2)(B)(iv).

In Section 523(a)(4), by contrast, Congress did not make the dischargeability of debts for “defalcation[s]” turn on proof of any heightened mental state. Instead, it required only that the debtor have committed the defalcation “while acting in a fiduciary capacity.” 11 U.S.C. 523(a)(4). That is, to be sure, a significant narrowing of the potentially broad category of “non-fraudulent default[s]” (see p. 11, *supra*), because it requires both that the debtor be a fiduciary and that he commit the defalcation in his fiduciary capacity. Cf. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934) (holding that, under the 1898 predecessor statute, the debtor “must have been a trustee before the wrong and without reference thereto”). Nevertheless, Section 523(a)(4) does not cabin the meaning of “defalcation” on the basis of the debtor’s mental state. Because “Congress has shown elsewhere in the same statute”—indeed, in the same subsection—“that it knows how to make” a mental-state requirement “manifest,” the Court should resist the assumption “that Congress has omitted from its adopted text” a mental-state requirement “that it nonetheless intends to apply.” *Jama v. ICE*, 543 U.S. 335, 341 (2005).

b. Petitioner principally relies (Br. 21, 23) on the *nosctur a sociis* canon of construction. But he does

not explain why the debtor's subjective mental state is the attribute necessary to make "defalcation" more like the other terms in Section 523(a)(4). It might be said with at least equal force that the distinguishing feature of embezzlement or larceny is the acquisition or retention of property to which one is not entitled. At least where (as here) the relevant "defalcation" is a trustee's unauthorized and self-dealing diversion of trust assets, such a violation of the trustee's duty of loyalty bears a close resemblance to the other wrongs enumerated in Section 523(a)(4).

Moreover, the specific use that petitioner attempts to make of the canon in the context of Section 523(a)(4) would be inconsistent with the exception from discharge contained in 11 U.S.C. 523(a)(19). For purposes of Section 523(a)(4), petitioner suggests (Br. 23) that the presence of "fraud" would be inconsistent with allowing "[m]ere negligence or even recklessness \* \* \* to warrant an exception from discharge." But Section 523(a)(19) applies to, *inter alia*, orders for penalties associated with either "the violation of any of the Federal securities laws" or "common law fraud, deceit, or manipulation in connection with the purchase or sale of any security." 11 U.S.C. 523(a)(19)(A)(i)-(ii) and (B)(iii). Under petitioner's approach, that reference to "common law fraud, deceit, or manipulation"—which closely tracks much of his proposed mental-state standard (Pet. Br. 23)—should also limit the accompanying securities-law violations to those that were committed with ill intent. But civil penalties are available for violations of the securities laws that involve only negligence or "reckless disregard of a regulatory requirement," *e.g.*, 15

U.S.C. 78u(d)(3)(B)(i)-(iii),<sup>11</sup> and the plain text of Section 523(a)(19) unambiguously encompasses penalties for securities-law violations of that nature. Petitioner's approach would therefore distinguish among securities-law violations for purposes of bankruptcy discharges in a way that Congress did not specify.

c. Petitioner's attempt to remake "defalcation" in the image of fraud, embezzlement, and larceny also threatens to deprive "defalcation" of any independent role in the statute, notwithstanding the Court's "duty to give effect, if possible, to every clause and word of a statute." *Duncan v. Walker*, 533 U.S. 167, 174 (2001) (internal quotation marks omitted). As Judge Learned Hand concluded for the Second Circuit when discussing Section 523(a)(4)'s predecessors: "Whatever was the original meaning of 'defalcation,' it must [in the 1867 Act] have covered other defaults than deliberate malversations, else it added nothing to the words 'fraud or embezzlement.'" *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (1937).

Indeed, the two courts of appeals that have adopted petitioner's approach have acknowledged that, although they use the *noscitur a sociis* canon to infer a heightened mental state for "defalcation," the anti-surplusage principle prevents them from requiring the *same* mental state that is associated with fraud, embezzlement, and larceny. See *In re Hyman*, 502 F.3d 61, 68 (2d Cir. 2007), cert. denied, 555 U.S. 1097

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<sup>11</sup> See *SEC v. Moran*, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) (imposing first-tier civil penalty on investment adviser who engaged in no "intentional wrongdoing" but who breached his "duty to act in the best interest" of his client, "fail[ed] to recognize the harm that his negligence caused," and did not adequately understand "the significance of his actions").



(2009); *In re Baylis*, 313 F.3d 9, 20 (1st Cir. 2002). That inherently malleable process—of lending to one word an attribute that is loosely inspired by, but not the same as, those of its associates—is no longer a recognizable application of the *noscitur a sociis* canon.

d. Finally, the drafting history of Section 523(a)(4) counsels against petitioner's reading. As petitioner notes (Br. 14 n.3), the Commission on the Bankruptcy Laws of the United States recommended in 1973 that the terms "defalcation" and "misappropriation" be omitted from the relevant exception to dischargability because they were "overbroad and uncertain of meaning." *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. 2, at 139 (1973). The version of the Bankruptcy Code adopted by the House of Representatives followed that recommendation and would have eliminated both terms from Section 523(a)(4). See H.R. Rep. No. 595, 95th Cong., 1st Sess. 364 (1977) (*House Report*). The Senate version, however, retained both terms. See S. Rep. No. 989, 95th Cong., 2d Sess. 79 (1978).

The enacted version of the Code reflects Congress's decision to *retain* "defalcation" (but not "misappropriation") and place it alongside fraud in a fiduciary capacity, embezzlement, and larceny. 11 U.S.C. 523(a)(4).<sup>12</sup> In light of that apparently deliberate deci-

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<sup>12</sup> The fact that Congress *rejected* the House's attempt to delete "defalcation" seriously undermines the conclusion of petitioner's amicus (Brunstad Br. 28) that "[t]he limited legislative history that is available indicates that [S]ection 523(a)(4) was intended to reach debts incurred through a debtor's malfeasance." The passage that the amicus quotes is from the *House Report* (at 364). Because the

sion, the Court should not strip “defalcation” of its historic meaning, which, as discussed above, did not require proof of scienter (at least in the context of a self-dealing and unauthorized diversion of trust assets).

**3. *Historical practice supports treating a trustee’s unauthorized and self-dealing diversion of trust assets as a “defalcation”***

To the extent that the Court finds the term “defalcation” in its present statutory context to be ambiguous, “pre-Code practices \* \* \* can be relevant to the interpretation of an ambiguous text” in the Bankruptcy Code. *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2073 (2012).

As noted above, the term “defalcation” was first connected with nondischargeability in the 1841 bankruptcy law. Section 1 of that law defined the class of persons eligible for bankruptcy to include “persons \* \* \* owing debts, which shall not have been created in consequence of a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity.” Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 441 (repealed 1843). Section 4 authorized “a full discharge from all [of a bankrupt’s] debts,” but then made that discharge unavailable to “any person who, after the passing of this act, shall apply trust funds to his own use.” *Id.* § 4, 5 Stat. 443-444.

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bill discussed in the *House Report* would have included only embezzlement and larceny in the provision that was ultimately enacted as Section 523(a)(4), the *House Report* sheds no light on Congress’s understanding of the word “defalcation.”



This Court considered Sections 1 and 4 of the 1841 Act in *Chapman v. Forsyth*, 43 U.S. (2 How.) 202, 207-208 (1844). It recognized that the reference in Section 4 to a debtor who “appl[ies] trust funds to his own use” would “cover[] the enumerated cases in the first section” (involving a “defalcation” in a fiduciary context). *Ibid.* In order to avoid that potential redundancy, the Court construed Section 1 as withholding specific *debts* from bankruptcy-court jurisdiction, and Section 4 as denying a discharge to the individual *debtor* (even for debts that were not associated with a misuse of trust funds). *Id.* at 208. A necessary premise of the Court’s reasoning was its recognition that the application of “trust funds to [the trustee’s] own use” was a “defalcation”—even though there was no heightened mental state associated with the statute’s bare reference to “apply[ing] trust funds to [one’s] own use.”

As petitioner notes (Br. 11), subsequent decisions of this Court did not directly address the meaning of “defalcation” in the 1841 Act or its successors. At a time when the nondischargeability provision of the 1867 Act did not require that a fraud—as opposed to a defalcation—occur in a fiduciary capacity (see *Crawford v. Burke*, 195 U.S. 176, 189 (1904)), the Court held that the “fraud” must be an actual fraud, rather than one that is merely implied by law and “may exist without the imputation of bad faith or immorality.” *Neal v. Clark*, 95 U.S. 704, 709 (1878). That holding is now reflected in 11 U.S.C. 523(a)(2)(A), rather than Section 523(a)(4) (in which fraud is expressly limited to the

fiduciary context). See 124 Cong. Rec. 32,399 (1978) (statement of Rep. Edwards).<sup>13</sup>

The Court's opinion in *Davis, supra*, reiterated the longstanding conclusion (which this Court first articulated in 1844 in *Chapman*) that the reference to fiduciary status in Section 523(a)(4)'s predecessors rendered a debt dischargeable only if the debtor was "a trustee before the wrong [that resulted in the debt] and without reference thereto." 293 U.S. at 333. Petitioner appears to read *Davis* as suggesting that the predecessor to Section 523(a)(4), which was located at Section 17(4) of the Bankruptcy Act of 1898 (11 U.S.C. 35(4) (1925)), was not satisfied because the actions at issue in that case were not "actuated by willful, malicious or criminal intent." Pet. Br. 13 (quoting *Davis*, 293 U.S. at 332). In fact, the sentence that petitioner quotes came from a part of the Court's opinion pertaining to the exception from discharge in Section 17(2) of the Bankruptcy Act (11 U.S.C. 35(2) (1925))—a predecessor to what is now in Section 523(a)(6))—which applied to "willful and malicious injuries to the person or property of another." 293 U.S. at 331-332. After finding Section 17(2) inapplica-

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<sup>13</sup> Petitioner's amicus focuses (Brunstad Br. 24, 29) on the decision in *Keime v. Graff*, 14 F. Cas. 218 (W.D. Pa. 1878) (No. 7650), which described "defalcation" as "import[ing] a greater degree of culpability than that which attaches to a refusal or failure to pay a debt." *Id.* at 220. The passage in question, however, inferred that level of culpability not from the term "defalcation" alone but from the fact that, under the 1867 Act, the defalcation must have occurred while the debtor was "acting in any fiduciary character." *Ibid.* That simply means, however, that the level of culpability is one consistent with a breach of fiduciary duty—which is not the same as the "extreme recklessness" standard that petitioner advocates.

ble because of the lack of willfulness or malice, the Court turned to Section 17(4) (the predecessor to Section 523(a)(4)) to address the respondent's contention that, "irrespective of willfulness or malice," there had been "fraud or misappropriation while acting in a fiduciary capacity." *Id.* at 333. In its discussion of the latter provision, the Court did not suggest that the lack of willfulness, malice, or criminal intent doomed the respondent's claim. Instead, it held merely that the debtor had not been a trustee (i.e., had not been acting in a fiduciary capacity) at the time of the wrong. *Id.* at 333-334.

Finally, Judge Hand's opinion for the Second Circuit in *Herbst, supra*, supports the view that, at least where the relevant breach of trust consists of diverting trust assets to a use that is ultimately held to be unauthorized, a "defalcation" occurs regardless of the fiduciary's state of mind. In *Herbst*, an individual was appointed receiver of real property in a foreclosure suit and was awarded \$5,674.54 by the trial court after the property was sold. 93 F.2d at 511. He spent the money without attempting to ascertain whether the award would be appealed, and he declared bankruptcy after the state appellate court disallowed the award. *Ibid.* Without purporting to decide the scope of the term "defalcation" in other circumstances, the Second Circuit held that "when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a 'defalcation' though it may not be a 'fraud,' or an 'embezzlement,' or perhaps not even a 'misappropriation.'" *Id.* at 512. The court in *Herbst* did not hold that the receiver (who had received the funds pursuant to the state trial court's order) had acted recklessly or with

wrongful intent; rather, the court found it sufficient that the receiver had taken and spent the money with actual or constructive knowledge that the award was subject to possible reversal on appeal. See *ibid.* As the same court explained when it again relied on such constructive knowledge to find misappropriation that made a debt nondischargeable: "The character of the liability imposed upon a fiduciary for appropriating property of his cestui in violation of his duty is the same whether he has actual knowledge that the law imposes the duty or is merely charged with such knowledge." *In re Hammond*, 98 F.2d 703, 705 (2d Cir.), cert. denied, 305 U.S. 646 (1938).

Thus, when Congress enacted Section 523(a)(4) in 1978, retaining the word "defalcation" but omitting "misappropriation," the case law under that provision's statutory predecessors gave Congress no reason to believe that "defalcation" would be read as requiring a mental state of at least extreme recklessness.

**B. Even In The Absence Of Any Ultimate Loss Of The Trust Principal, A Trustee's Diversion Of Trust Assets To His Own Benefit May Be A "Defalcation"**

Petitioner also contends that, even apart from a heightened mental state, a "defalcation" occurs only when there has been "a 'failure to account' for entrusted property or a 'shortage in accounts.'" Pet. Br. 26. Petitioner suggests (*id.* at 8, 27) that those conditions for a "defalcation" cannot be satisfied if there is ultimately "no loss of the trust principal." Petitioner's amicus similarly contends that defalcations are limited to "wrongdoing resulting in actual loss," an "ultimate deficiency in the funds entrusted," or "the depletion of entrusted funds." Brunstad Br. 11, 26, 28. But the



serious breach of fiduciary duty associated with a defalcation is present when the trust's assets are taken away without authorization, even if there is no ultimate loss of trust principal.

1. In support of his suggested "loss" requirement, petitioner quotes dictionary definitions from 1755 and 1828 to the effect that a defalcation means a "diminution," "abatement," or "deduction." Pet. Br. 27 (quoting 1 Samuel Johnson, *A Dictionary of the English Language* s.v. "defalcation" (1755); Noah Webster, *An American Dictionary of the English Language* 56 (1828)). As discussed above, however, by 1846, dictionaries were already attesting to the more relevant (and broader) sense of the term as "a breach of trust by one who has charge or management of money." 4 *OED* 369. Petitioner cannot dispute that an unauthorized and self-dealing diversion of assets from a trust satisfies that definition.

Petitioner suggests (Br. 27) that the omission of "misappropriation" from Section 523(a)(4) in 1978 indicated Congress's intent to permit discharge for "misappropriations that do not ultimately result in a shortage in accounts." But in light of the modern dictionary definitions quoted above, it is more likely that Congress omitted "misappropriation" and kept "defalcation" because it reasonably viewed those two terms as redundant in the context of a fiduciary's misuse of trust assets. Although the *House Report* (at 364) contains a glancing reference to ensuring that certain debts would be nondischargeable when "injury is in fact inflicted," that report assumed that "defalcation" would be omitted from the provision.

2. In any event, a self-dealing trustee who profits from his unauthorized diversion of trust assets has

inflicted an injury on the trust. Such a trustee generally must disgorge his profits to the trust (and may also be required to pay the attorney's fees and costs that were incurred in pursuing his breach, which are themselves a quantifiable loss).

Self-dealing with trust assets is a paradigmatic misuse or misappropriation of funds. It violates the duty of loyalty, which this Court has recognized is "[t]he most fundamental duty owed by the trustee to the beneficiaries of the trust." *Pegram v. Herdrich*, 530 U.S. 211, 224 (2000) (quoting 2A Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170, at 311 (4th ed. 1987)); see 3 Restatement (Third) of Trusts § 78(2) (2005) ("Except in discrete circumstances, the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests."); *id.* § 78 cmt. a ("[T]he rule of Subsection (2) strictly prohibits the trustee from entering into transactions involving the trust property \* \* \* if the transaction is for the trustee's personal account (self-dealing)"); *id.* § 78 cmt. d ("nor may the trustee personally borrow money from, lend funds to, or exchange property with the trust"; "it is immaterial to the question of breach of trust \* \* \* that the trustee has acted in good faith and for a fair consideration").<sup>14</sup>

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<sup>14</sup> Petitioner notes that his borrowing from the trust could have been authorized if he had secured the consent of all of its beneficiaries. Br. 25 (citing 3 Restatement (Third) of Trusts § 78 cmt. c(3)). But petitioner cannot dispute the state court's finding that his conduct fell within none of the discrete circumstances in which self-dealing by a trustee is permitted. Pet. App. 55a.



Even when the diverted funds are not ultimately lost to the trust because their equivalent has been returned, “the trustee is subject to such liability as may be necessary to prevent the trustee from benefiting individually from the breach of trust.” 4 Restatement (Third) of Trusts § 95 cmt. b (2011). That may require the trustee to repay “the amount of any benefit to the trustee personally as a result of the breach,” as well as to reimburse “the attorneys fees and other litigation costs of a successful plaintiff.” *Id.* § 100(b) & cmt. b(2); see *Mosser v. Darrow*, 341 U.S. 267 (1951) (holding reorganization trustee personally liable for profits earned by employees who had traded, with his permission, on securities of subsidiaries of the relevant trusts, even though the trustee himself made no profit and the trust incurred no financial loss); cf. *Leigh v. Engle*, 727 F.2d 113, 119-122 (7th Cir. 1984) (mere fact that trust lost no money in challenged investment transactions, and in fact “profited handsomely,” did not preclude ERISA cause of action for breach of fiduciary duty).

3. Despite petitioner’s reliance on the *noscitur a sociis* canon with respect to mental state, he is notably silent about whether the other terms in Section 523(a)(4) require the actual loss of property he believes is required by “defalcation.” Petitioner’s amicus asserts (Brunstad Br. 11), without citation, that requiring a “depletion of entrusted funds” would “align[] the concept of ‘defalcation’ with” the other terms in Section 523(a)(4)—“fraud,” “embezzlement,” and “larceny”—“all of which also connote some form of financial loss.”

Contrary to the amicus’s unsupported assertion, the fact that petitioner ultimately repaid the loans he

had taken from the trust would not, by itself, suffice to protect him from charges of fraud, embezzlement, or larceny. “[I]t is well-established law that permanent loss is no part of offenses such as embezzlement, larceny or misappropriation,” and that “[r]estitution is no defense to such offenses.” *Rakes v. United States*, 169 F.2d 739, 743 (4th Cir.), cert. denied, 335 U.S. 826 (1948). There is, for instance, no loss requirement in a federal criminal prosecution under 18 U.S.C. 641 for embezzling, stealing, or converting property of the United States. See, e.g., *United States v. Milton*, 8 F.3d 39, 44 (D.C. Cir. 1993) (“No one \* \* \* has explained why Congress would have made property loss an element of a section 641 offense when, historically, there was no such element.”), cert. denied, 513 U.S. 919 (1994).<sup>15</sup> Nor is there a loss requirement in prosecutions under 18 U.S.C. 656 (for theft, embezzlement, or misapplication of bank funds by a bank officer or employee), or under various other federal theft or embezzlement statutes. See, e.g., *United States v. Bailey*, 734 F.2d 296, 304-305 (7th Cir.) (citing cases applying several statutes), cert. denied, 469 U.S. 931 (1984). Similarly, “the lack of financial loss is no defense” in a criminal fraud case. 3 Wayne R. LaFare, *Substantive Criminal Law* § 19.7(i)(3), at 135 (2d ed. 2003). Furthermore, the intentional taking of assets with the intention of replacing them at a later

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<sup>15</sup> In *United States v. Collins*, 464 F.2d 1163 (1972), the Ninth Circuit identified “an actual property loss” as an element of a Section 641 offense. *Id.* at 1165. But, as the D.C. Circuit noted in *Milton*, the Ninth Circuit in subsequent decisions “has itself recast *Collins* to mean that if someone other than the government feels the pinch, this tends to indicate that the stolen property was not the government’s.” 8 F.3d at 44 (citing cases from 1979 and 1988).

point with an equivalent amount of money would not necessarily preclude criminal liability for embezzlement or fraud.<sup>16</sup>

As the relevant decisions explain, “neither the intention to replace” unlawfully taken property “nor the actual replacement is a defense when conversion is proved” because

[t]he criminal sanction of the statute is imposed to prohibit the unlawful use of another’s property, and the statute does not permit the converter to subject the owner to the risk of loss and relieve the converter of criminal liability if his operations are successful and he makes restitution.

*Elmore v. United States*, 267 F.2d 595, 601 (4th Cir.), cert. denied, 361 U.S. 832 (1959).

The same should be true in the context of a defalcation, where the absence of a loss of principal does not establish that a trustee’s unauthorized diversion of trust assets is intrinsically less culpable than the other kinds of conduct identified in Section 523(a)(4).

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<sup>16</sup> See 3 LaFare, *Substantive Criminal Law* § 19.6(f)(3), at 111 & n.67 (in the context of embezzlement, “[i]t is uniformly held that the intent to restore” an “equivalent” amount of converted money at a later date “is no defense to embezzlement,” even when the defendant has “a substantial ability to do so”) (citing cases); *id.* § 19.7(f)(2), at 132 n.87 (“[a]n intent to pay for the property obtained, or otherwise to return the equivalent but not the very property, although it may be accompanied by an ability to do so, does not negative the intent to defraud”). The question is less clear with respect to larceny. See *id.* § 19.5(c), at 92-93 (finding it unclear whether “one who takes another’s property intending, and having the financial ability, to pay for it or otherwise to restore the equivalent (rather than the property itself) has a defense to a charge of larceny”).

**C. The Policy Interests Underlying Section 523(a)(4) Are Served By Refusing To Discharge Debts Resulting From A Trustee's Unauthorized And Self-Dealing Diversion Of Trust Assets**

Petitioner appeals to the Bankruptcy Code's general "fresh start" policy (Br. 9, 23-24), under which a discharge gives a debtor "a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). But Section 523(a) reflects Congress's determination that "the creditors' interest in recovering full payment of debts in [the enumerated] categories outweigh[s] the debtors' interest in a complete fresh start." *Cohen v. de la Cruz*, 523 U.S. 213, 222 (1998) (internal quotation marks omitted). Thus, in *United States v. Sotelo*, 436 U.S. 268 (1978), the Court noted that the "fresh start" policy provides "little assistance in construing a section expressly designed to make some debts nondischargeable." *Id.* at 280; see *Bruning v. United States*, 376 U.S. 358, 361 (1964) (recognizing that Section 523's predecessor "is not a compassionate section for debtors" because "it demonstrates congressional judgment that certain problems \* \* \* override the value of giving the debtor a wholly fresh start."). As a result, the Court has often adopted constructions of Section 523(a) that favored creditors rather than debtors. See, e.g., *Cohen*, 523 U.S. at 223 (holding that treble-damages award for fraud was nondischargeable under 11 U.S.C. 523(a)(2)(A) even when it exceeded the value of what the debtor had fraudulently obtained); *Grogan v. Garner*, 498 U.S. 279, 287 (1991) (refusing to impose a heightened burden of proof on



creditors attempting to demonstrate that a debt was one for “actual fraud” under 11 U.S.C. 523(a)(2)(A)).

Even when a fiduciary does not engage in fraud or intentional wrongdoing, his knowing use of trust property for other than its intended purpose constitutes serious misconduct. The equitable arguments against discharge are particularly compelling when the fiduciary diverts trust assets to his own use, thereby enriching himself.<sup>17</sup> As this Court has explained: “To deter the trustee from all temptation and to prevent any possible injury to the beneficiary, the rule against a trustee dividing his loyalties must be enforced with ‘uncompromising rigidity.’” *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-330 (1981) (quoting *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.)); cf. *Mosser*, 341 U.S. at 271 (“Equity tolerates in bankruptcy trustees no interest adverse to the trust.”).

As explained above (see pp. 17-18, *supra*), under Section 4 of the 1841 Act, trustees who engaged in such conduct were categorically ineligible for discharge in bankruptcy even as to their *non*-fiduciary debts. Congress relaxed that debtor-based restriction in subsequent bankruptcy legislation, but, in Section 523(a)(4), it has persisted in its “desire to protect trust relationships” by preventing discharge of fiduciary debts. *In re Patel*, 565 F.3d 963, 967 (6th Cir. 2009); see *ibid.* (“[W]hen the bankrupt is a trustee and the creditor is a trust beneficiary, § 523(a)(4) points the

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<sup>17</sup> Whether a fiduciary’s receipt of trust funds is authorized will necessarily depend on the type of trust involved and the specific terms of the trust. The court of appeals concluded that petitioner is collaterally stopped from arguing that his self-dealing conduct was authorized. Pet. App. 6a-7a.

needle away from discharge; it is yet another example of the law's imposition of high standards of loyalty and care on trustees."); *In re Johnson*, 691 F.2d 249, 256 (6th Cir. 1982) ("[T]he requisite 'badness[]' \* \* \* is supplied by an individual's special legal status with respect to another, with its attendant duties and high standards of dealing, and the act of breaching these duties.").

There is no reason to conclude that a trustee who engages in an unauthorized and self-dealing diversion of trust assets, from which he gains financial benefits, is the kind of "honest but unfortunate debtor" (*Local Loan Co.*, 292 U.S. at 244) who deserves to be unburdened of the obligation to pay his debt to the trust or its beneficiaries. Such a core breach of fiduciary duty is sufficiently culpable to warrant making the resulting debt nondischargeable.<sup>18</sup>

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<sup>18</sup> This does not mean that *every* breach of fiduciary duty constitutes a defalcation, or that Section 523(a)(4) would never require proof of a particular mental state to establish that a particular kind of breach triggered nondischargeability. Some fiduciary breaches may involve a negligent failure to carry out a fiduciary duty that does not involve a diversion of trust assets to unauthorized purposes, or the kind of constructive knowledge that courts have considered sufficient for a defalcation. Such breaches are relatively far afield from the core breach of trust that was described in Section 4 of the 1841 Act (i.e., application of trust assets to the fiduciary's personal use). Cf. *In re Hemmeter*, 242 F.3d 1186, 1191 (9th Cir. 2001) (declining to find defalcation by debtor for losses associated with ESOP and 401K plan stemming from decline in stock value of stock in which plans were specifically authorized to invest).



**D. Petitioner's Conduct Constituted A "Defalcation While Acting In A Fiduciary Capacity"**

The Illinois state court found that petitioner "was clearly involved" in unauthorized "self-dealing transactions" when he diverted trust assets to himself and his mother, and that he therefore "breached his fundamental fiduciary duty" of loyalty as trustee by "put[ting] himself in a position in conflict with the interests of the beneficiaries." Pet. App. 51a, 52a, 54a-57a. It found that petitioner had "failed to make an annual accounting of the trust until approximately 1997," and that he had therefore failed to account, as required, for transactions in which "he borrowed money from [the trust assets] and then loaned it out." *Id.* at 58a. The state court also concluded that, as a result of his fiduciary breaches, petitioner had "received" \$250,000 in benefits and that the trust was entitled to \$35,000 in attorney's fees and litigation costs (\$25,000 of which would be reimbursed to the beneficiaries that had pursued the suit against petitioner). *Id.* at 47a, 48a-49a. In light of those findings, the court of appeals in the bankruptcy case correctly concluded that, as a trustee, petitioner "certainly should have known that he was engaging in self-dealing, given that he knowingly benefited from the loans," and that the debt was for a defalcation in petitioner's fiduciary capacity. *Id.* at 11a.

1. Petitioner relies on the state court's observation that he did not "appear to have had a malicious motive." Pet. Br. 26 (quoting Pet. App. 45a). The quoted statement, however, does not logically imply that petitioner's conduct was innocent. Although petitioner asserts (*id.* at 3) that he "did not believe the loans were improper," he does not suggest that his belief

was founded on a mistake of fact. It is undisputed that those self-dealing transactions were not actually authorized by trust law or by the terms of the trust. Pet. App. 6a-7a, 24a-25a, 34a, 40a, 54a-57a. Petitioner's status as a trustee imposed special obligations on him, and "[i]gnorance of the law should be no excuse to defalcation, whether due to negligence or not, where that ignorance leads to fiduciary default." *In re Richardson*, 178 B.R. 19, 29 (Bankr. D.D.C.), aff'd, 193 B.R. 378 (D.D.C. 1995), aff'd, 107 F.3d 923 (D.C. Cir.), cert. denied, 522 U.S. 851 (1997); cf. *Mosser*, 341 U.S. at 274 ("[A] trusteeship is serious business and is not to be undertaken lightly or so discharged. The most effective sanction for good administration is personal liability for the consequences of forbidden acts[.]").

For purposes of establishing fiduciary "defalcations," imputing constructive knowledge of fundamental legal obligations to fiduciaries has a distinguished pedigree. See *Herbst*, 93 F.2d at 512; p. 21, *supra*. Even the First Circuit—which has adopted petitioner's proposed mental-state requirement of "extreme recklessness"—is willing to "presume[]" that there is sufficient fault to constitute a defalcation when the circumstances reveal, as here, a breach of the trustee's fundamental duty of loyalty. *Baylis*, 313 F.3d at 20-21. Petitioner would require a creditor in an adversary proceeding, often years after a debt was litigated to judgment, to prove that the debtor had actual knowledge of the most fundamental duty in trust law. That approach would be tantamount to imposing the kind of heightened, clear-and-convincing-evidence standard of proof that this Court rejected in *Grogan* in the context of the discharge exception for actual

fraud. See 498 U.S. at 286-291. The Court should similarly decline petitioner's invitation (Br. 26) to hold that "respondent failed to carry its burden to demonstrate that petitioner acted with a wrongful state of mind sufficient to support a finding of defalcation under § 523(a)(4)."

2. The Court should also reject petitioner's contention (Br. 27) that there was no defalcation here because "[t]here was no failure to account for the entrusted property and no loss of the trust principal." As an initial matter, petitioner's assertion that "[t]here was no failure to account" is belied by the state court's finding that, between 1981 and 1997, petitioner did indeed fail to account to the beneficiaries, as required by state law, for his self-dealing transactions with trust assets. See Pet. App. 58a. Moreover, petitioner's statement that the state-court judgment was only for "the benefit he received" and "not a reckoning for any loss" (Br. 28) is clearly wrong with respect to the \$35,000 portion that was to reimburse the trust and its beneficiaries for attorney's fees and other costs incurred to remedy his fiduciary breaches.

In any event, as discussed above (pp. 23-24, *supra*), trust law appropriately requires a trustee who profits from his unauthorized self-dealing with trust assets to disgorge that benefit. Cf. *Mosser*, 341 U.S. at 273 ("[T]he prohibition is not merely against injuring the estate—it is against profiting out of the position of trust."). Thus, apart from the \$35,000 in attorney's fees and costs, the remainder of the damages award in the state-court action represented money that petitioner ought to have paid over to the trust but did not. See Resp. Br. 22-24.

The fact that petitioner ultimately returned the borrowed funds—but not the \$250,000 in benefits that he had received—did not suffice to remedy his breach. That is so for two reasons. During the interim between the improper loans and their eventual repayment, petitioner's conduct resulted in a tangible "shortage in accounts" (Pet. Br. 27). And even after the loans were repaid, petitioner failed to perform his duty as trustee to pay over the profits he had realized. As with embezzlement, fraud, and larceny, petitioner's subsequent repayment of the "trust principal" (*ibid.*) cannot erase his underlying defalcation. See pp. 24-26, *supra*.

#### CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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JANUARY 2013



## **APPENDIX**

11 U.S.C. 523 (2006 & Supp. V 2011) provides in relevant parts as follows:

### **Exceptions to discharge**

(a) A discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt—

\* \* \* \* \*

(2) for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—

(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;  
[or]

(B) use of a statement in writing—

(i) that is materially false;

(ii) respecting the debtor's or an insider's financial condition;

(iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and

(iv) that the debtor caused to be made or published with intent to deceive;

\* \* \* \* \*

(3) neither listed nor scheduled under section 521(a)(1) of this title, with the name, if known to the debtor, of the creditor to whom such debt is owed, in time to permit—



(A) if such debt is not of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim, unless such creditor had notice or actual knowledge of the case in time for such timely filing; or

(B) if such debt is of a kind specified in paragraph (2), (4), or (6) of this subsection, timely filing of a proof of claim and timely request for a determination of dischargeability of such debt under one of such paragraphs, unless such creditor had notice or actual knowledge of the case in time for such timely filing and request;

(4) for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;

\* \* \* \* \*

(6) for willful and malicious injury by the debtor to another entity or to the property of another entity;

\* \* \* \* \*

(11) provided in any final judgment, unreviewable order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal depository institutions regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union;

(12) for malicious or reckless failure to fulfill any commitment by the debtor to a Federal depository institutions regulatory agency to maintain the capital of an insured depository institution, except that this paragraph shall not extend any such commit-

ment which would otherwise be terminated due to any act of such agency; [or]

\* \* \* \* \*

(19) that

(A) is for

(i) the violation of any of the Federal securities laws (as that term is defined in section 3(a)(47) of the Securities Exchange Act of 1934), any of the State securities laws, or any regulation or order issued under such Federal or State securities laws; or

(ii) common law fraud, deceit, or manipulation in connection with the purchase or sale of any security; and

(B) results, before, on, or after the date on which the petition was filed, from—

(i) any judgment, order, consent order, or decree entered in any Federal or State judicial or administrative proceeding;

(ii) any settlement agreement entered into by the debtor; or

(iii) any court or administrative order for any damages, fine, penalty, citation, restitutionary payment, disgorgement payment, attorney fee, cost, or other payment owed by the debtor.

\* \* \* \* \*

(c)(1) Except as provided in subsection (a)(3)(B) of this section, the debtor shall be discharged from a debt of a kind specified in paragraph (2), (4), or (6) of subsection (a) of this section, unless, on request of the

creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under paragraph (2), (4), or (6), as the case may be, of subsection (a) of this section.

(2) Paragraph (1) shall not apply in the case of a Federal depository institutions regulatory agency seeking, in its capacity as conservator, receiver, or liquidating agent for an insured depository institution, to recover a debt described in subsection (a)(2), (a)(4), (a)(6), or (a)(11) owed to such institution by an institution-affiliated party unless the receiver, conservator, or liquidating agent was appointed in time to reasonably comply, or for a Federal depository institutions regulatory agency acting in its corporate capacity as a successor to such receiver, conservator, or liquidating agent to reasonably comply, with subsection (a)(3)(B) as a creditor of such institution-affiliated party with respect to such debt.

\* \* \* \* \*

**AMICUS  
CURIAE  
BRIEF**

No. 11-1518

FILED

JAN 14 2013

OFFICE OF THE CLERK

IN THE

# Supreme Court of the United States

RANDY CURTIS BULLOCK,

*Petitioner,*

—v.—

BANKCHAMPAIGN, N.A.,

*Respondent.*

ON WRIT OF CERTIORARI TO THE UNITED STATES  
COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

**BRIEF IN SUPPORT OF RESPONDENT FOR *AMICI CURIAE*  
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January 14, 2013

## TABLE OF CONTENTS

|                                                                                                                                                                                                                                                                                                                                               | PAGE |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| TABLE OF AUTHORITIES.....                                                                                                                                                                                                                                                                                                                     | iv   |
| INTEREST OF THE <i>AMICI CURIAE</i> .....                                                                                                                                                                                                                                                                                                     | 1    |
| SUMMARY OF ARGUMENT .....                                                                                                                                                                                                                                                                                                                     | 2    |
| ARGUMENT .....                                                                                                                                                                                                                                                                                                                                | 8    |
| POINT I                                                                                                                                                                                                                                                                                                                                       |      |
| THE FIDUCIARY DEFALCATION<br>PROVISION OF § 523(a)(4) SHOULD<br>BE INTERPRETED TO IMPLEMENT<br>THE CONGRESSIONAL PURPOSE TO<br>PROTECT BENEFICIARIES OF TRUST<br>FUNDS FROM NONCOMPLIANCE<br>BY TRUSTEES AND SIMILAR<br>FIDUCIARIES WITH THE STANDARDS<br>OF CONDUCT REQUIRED BY THE<br>FIDUCIARY DUTIES IMPOSED<br>BY THE LAW OF TRUSTS..... | 8    |
| A. The Origin Of Fiduciary Defalcation<br>Provisions .....                                                                                                                                                                                                                                                                                    | 10   |
| B. Defalcation Consists Of Conduct<br>That Fails To Comply With The<br>Standard Required For Compliance<br>With The Particular Fiduciary<br>Duty That Has Been Breached .....                                                                                                                                                                 | 14   |



|                                                                                                                                                                           | PAGE |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------|
| 1. Types of Fiduciary Duties<br>and Their Compliance<br>Standards Under the Law<br>of Trusts .....                                                                        | 14   |
| 2. Petitioner Wrongly Urges<br>Fraud, Embezzlement and<br>Larceny as the Standard<br>Under Clause (4) and<br>Misapplies the Canon,<br><i>Noscitur a Sociis</i> .....      | 18   |
| 3. Negligent Conduct Constitutes<br>Defalcation When Reasonable<br>Care is the Applicable<br>Standard of Conduct Under<br>the Law of Trusts .....                         | 20   |
| 4. Judge Learned Hand's Opinion<br>in <i>Herbst</i> Illuminates that<br>Fiduciary Duties Are Inherent<br>in Clause (4) .....                                              | 21   |
| C. Clause (4)'s Legislative History<br>Indicates That Defalcation Means<br>Noncompliance With The Standard<br>Fixed By The Particular Fiduciary<br>Duty In Question ..... | 27   |

POINT II

|                                                                                                                                                                         |    |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----|
| CONGRESS AND THIS COURT<br>DETERMINED THAT THE INTERESTS<br>OF TRUST BENEFICIARIES<br>PROTECTED UNDER § 523(a)(4)<br>ARE PARAMOUNT TO A<br>DEBTOR'S "FRESH START" ..... | 32 |
| CONCLUSION.....                                                                                                                                                         | 35 |

# TABLE OF AUTHORITIES

| Cases                                                                                           | PAGE          |
|-------------------------------------------------------------------------------------------------|---------------|
| <i>BFP v. Resolution Trust Corp.</i> ,<br>511 U.S. 531 (1994) .....                             | 9, 19, 32     |
| <i>Bullock v. BankChampaign, N.A.</i> ,<br>670 F.3d 1160 (11th Cir. 2012) .....                 | <i>passim</i> |
| <i>Central Hanover Bank &amp; Trust Co.</i><br><i>v. Herbst</i> ,<br>93 F.2d 510 (1937) .....   | <i>passim</i> |
| <i>Chapman v. Forsyth</i> ,<br>43 U.S. 202 (1844) .....                                         | <i>passim</i> |
| <i>City of Chicago v. Envtl. Def. Fund</i> ,<br>511 U.S. 328 (1994) .....                       | 19            |
| <i>Cohen v. De La Cruz</i> ,<br>523 U.S. 213 (1998) .....                                       | 33            |
| <i>Commonwealth Land Title Co.</i><br><i>v. Blaszak</i> ,<br>397 F.3d 386 (6th Cir. 2005) ..... | 12            |
| <i>Crawford v. Burke</i> ,<br>195 U.S. 176 (1904) .....                                         | 12, 14        |
| <i>Davis v. Aetna Acceptance Co.</i> ,<br>293 U.S. 328 (1934) .....                             | 12, 14        |
| <i>Dewsnup v. Timm</i> ,<br>502 U.S. 410 (1992) .....                                           | 32            |
| <i>Dickerson v. Camden Trust Co.</i> ,<br>53 A.2d 225 (N.J. Ch. 1947) .....                     | 16            |
| <i>Dickerson v. Camden Trust Co.</i> ,<br>64 A. 2d 214 (N.J. 1949) .....                        | 16            |

|                                                                                                         | PAGE          |
|---------------------------------------------------------------------------------------------------------|---------------|
| <i>Estate of Neilson v. Simpson,</i><br>37 B.R. 132 (Bankr. D. N.H. 1984) .....                         | 30            |
| <i>Feinberg v. Adolph K. Feinberg</i><br><i>Hotel Trust,</i><br>922 S.W.2d 21 (Mo. Ct. App. 1996) ..... | 18            |
| <i>Gilbert v. Kolb,</i><br>37 A. 423 (Md. 1897) .....                                                   | 17            |
| <i>Grogan v. Garner,</i><br>498 U.S. 279 (1991) .....                                                   | 33            |
| <i>Hennequin v. Clews,</i><br>111 U.S. 676 (1884) .....                                                 | 13            |
| <i>In re Baylis,</i><br>313 F.3d 9 (1st Cir. 2002) .....                                                | <i>passim</i> |
| <i>In re Berman,</i><br>629 F.3d 761 (7th Cir. 2011) .....                                              | 22, 34        |
| <i>In re Cochrane,</i><br>124 F.3d 978 (8th Cir. 1997) .....                                            | 21            |
| <i>In re Harwood,</i><br>637 F.3d 615 (5th Cir. 2011) .....                                             | 34            |
| <i>In re Hyman,</i><br>502 F.3d 61 (2d Cir. 2007) .....                                                 | 22, 34        |
| <i>In re Patel,</i><br>565 F.3d 963 (6th Cir. 2009) .....                                               | 22            |
| <i>In re Sherman,</i><br>658 F.3d 1009 (9th Cir. 2011) .....                                            | 21            |
| <i>In re Uwimana,</i><br>274 F.3d 806 (9th Cir. 2001) .....                                             | 21            |

|                                                                                                    | PAGE   |
|----------------------------------------------------------------------------------------------------|--------|
| <i>Kawaauhau v. Geiger</i> ,<br>523 U.S. 57 (1998) .....                                           | 21     |
| <i>Marrama v. Citizens Bank of<br/>Massachusetts</i> ,<br>549 U.S. 365 (2007) .....                | 33     |
| <i>Meinhard v. Salmon</i> ,<br>249 N.Y. 458 (1928) .....                                           | 18     |
| <i>Midlantic Nat. Bank v. New Jersey<br/>Dep't of Env'tl. Prot.</i> ,<br>474 U.S. 494 (1986) ..... | 32     |
| <i>Mosser v. Darrow</i> ,<br>341 U.S. 267 (1951) .....                                             | 17     |
| <i>Neal v. Clark</i> ,<br>95 U.S. 704 (1877) .....                                                 | 13, 19 |
| <i>Noble v. Hammond</i><br>129 U.S. 65 (1889) .....                                                | 19     |
| <i>Quaif v. Johnson</i> ,<br>4 F.3d 950 (11th Cir. 1993) .....                                     | 22     |
| <i>United States v. Kimbell Foods, Inc.</i><br>440 U.S. 715 (1979) .....                           | 9      |
| <i>Upshur v. Briscoe</i> ,<br>138 U.S. 365 (1891) .....                                            | 13     |
| <i>Woods v. City Nat. Bank &amp;<br/>Trust Co. of Chicago</i> ,<br>312 U.S. 262 (1941) .....       | 18     |
| <i>Whitaker v. Estate of Whitaker</i> ,<br>663 N.E. 2d 681<br>(Ohio Ct. App. 1995) .....           | 18     |

**Statutes**

|                                                                    |               |
|--------------------------------------------------------------------|---------------|
| Bankruptcy Act of 1800 .....                                       | 11            |
| Bankruptcy Act of 1841, ch. 9,<br>5 Stat. 440 § 1 (1841) .....     | <i>passim</i> |
| Bankruptcy Act of 1867, ch. 176,<br>14 Stat. 517 § 33 (1867) ..... | 27            |
| Bankruptcy Act of 1898, ch. 541,<br>30 Stat. 544 § 17 (1898) ..... | 28            |
| Bankruptcy Act of 1938, ch. 575,<br>52 Stat. 840 § 17 (1938) ..... | 28, 29        |
| Bankruptcy Reform Act of 1978, Pub. L. No.<br>95-598 (1978) .....  | 29            |
| 11 U.S.C. § 523(a) .....                                           | <i>passim</i> |
| 11 U.S.C. § 523(a)(4) .....                                        | <i>passim</i> |
| 11 U.S.C. § 523(a)(6) .....                                        | 19, 21        |

**Legislative History**

|                                                                            |    |
|----------------------------------------------------------------------------|----|
| 124 Cong. Rec. H32,399<br>(daily ed. Sept. 28, 1978) .....                 | 30 |
| 124 Cong. Rec. S33,998<br>(daily ed. Oct. 5, 1978) .....                   | 30 |
| App. to the Cong. Globe, 25th Cong.,<br>2nd Sess. 16 (December 1838) ..... | 10 |
| H.R.Doc. No. 93-137, pt. 2 (1973) .....                                    | 29 |
| H. Rep. No. 95-595 (1977) .....                                            | 30 |
| S. Rep. No. 95-989 (1978) .....                                            | 30 |



**Other Authorities**

|                                                                                           |        |
|-------------------------------------------------------------------------------------------|--------|
| 2A Austin W. Scott,<br>THE LAW OF TRUSTS § 170.25<br>(W.F. Franchter ed., 4th 2001) ..... | 15, 25 |
| 16 Collier on Bankruptcy ¶ 523.10[1][d]<br>(16th ed. 2012) .....                          | 22     |
| BOGERT'S TRUST AND TRUSTEES § 541<br>(Dec. 2012).....                                     | 17     |
| RESTATEMENT (THIRD) OF THE LAW<br>OF TRUSTS § 78 (3d. ed. 2007) .....                     | 15     |

## INTEREST OF THE *AMICI CURIAE*<sup>1</sup>

The *Amici Curiae* are law professors who have a keen interest in bankruptcy law.<sup>2</sup> They study difficult and important issues that have troubled bankruptcy and appellate courts. The issue posed by this appeal, namely, what constitutes “defalcation” by a fiduciary within the meaning of the nondischargability provision of 11 U.S.C. § 523(a)(4), has vexed the nine Circuit Courts of Appeal, including the Eleventh Circuit below, that have addressed the issue. Their decisions neither provide any analytical basis for their varied holdings about the meaning of “defalcation” under clause (4), nor any meaningful guidance to the lower courts for applying that provision.

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<sup>1</sup> Pursuant to Rule 37 of this Court, the *Amici* file this brief with the written consent of both parties, which is on file with the Clerk. No counsel for a party authored this brief in whole or in part. No person or entity including the *Amici* or their counsel made a monetary contribution for the preparation of this brief.

<sup>2</sup> The *Amici* are the following law professors who teach at the law schools indicated next to their names: Richard Aaron, University of Utah- S.J.Quinney College of Law; Jagdeep S. Bhandari, Florida Coastal College of Law; Susan Block-Lieb, Fordham University School of Law; John Collen, St. John's University School of Law; Jessica Dawn Gabel, Georgia State University College of Law; Kenneth N. Klee, UCLA School of Law; George W. Kuney, University of Tennessee College of Law; Lois Lupica, University of Maine School of Law; Theresa J. Pulley Radwan, Stetson University College of Law; Nancy B. Rapoport, William S. Boyd School of Law-University of Nevada, Las Vegas; Marie T. Reilly, Penn State University-Dickinson School of Law; Keith Sharfman, St. John's University School of Law; Robert Zinman, St. John's University School of Law.

The *Amici* offer this *pro bono amicus* brief in support of Respondent to assist the Court as it considers the meaning of “defalcation” under clause (4). This brief sets forth a unique analysis of the meaning of “defalcation” based on the purpose of clause (4), its legislative history, and the jurisprudence of this Court. The analysis is also based on this Court’s explanation of the meaning of the fiduciary defalcation provision first set forth in the Bankruptcy Act of 1841 and the circumstances that led to its enactment, which underpin the fiduciary defalcation provision in the four major revisions of the bankruptcy laws, including the current fiduciary defalcation provision in § 523(a)(4) of the 1978 Bankruptcy Code.

The *Amici* represent no institution, group, or association, and they are not predisposed to the interests of debtors or creditors. Their sole purpose is to bring to the Court an understanding of the meaning of “defalcation” by a fiduciary under clause (4) based on a new analysis that is not offered by the Circuit Courts or by the parties to this appeal.

## SUMMARY OF ARGUMENT

The *Amici* urge affirmance of the order of the Circuit Court below, which held that the debtor’s self-dealing conduct consisting of borrowing from a trust fund of which he was the trustee, in violation of the trust agreement, was “a defalcation while acting in a fiduciary capacity” within the meaning of clause (4), and that his resulting debt thus was excepted from his discharge. Although the *Amici* believe that the result reached below was correct, they disagree with the approach used

by the Circuit Court below and the other Circuit Courts to determine what constitutes “defalcation” under clause (4).<sup>3</sup>

The *Amici* submit that “defalcation” under clause (4) means: noncompliance by the debtor with the standard of conduct required by the non-bankruptcy law of trusts under the particular fiduciary duty that has been breached by the debtor. They urge that “defalcation” under clause (4) depends upon a breach by the debtor of a fiduciary duty established by the law of trusts, which body of law provides the standards of conduct required for compliance with the various fiduciary duties. Whether there has been a breach of such duty turns on whether the debtor has failed to comply with such duty’s standard for compliance. Accordingly, “defalcation” within the meaning of clause (4) consists of a debtor’s noncompliance with the standard of conduct required by the particular fiduciary duty that he or she has breached. The *Amici*’s approach to determine whether a debtor has defalcated carries out the purpose of clause (4) to protect the beneficiaries of specific trust funds and offers a single approach to replace the many different standards for “defalcation” under clause (4) promulgated by the various Circuit Courts.

There are two types of fiduciary duties under the law of trusts. One type, such as the duty requiring undivided loyalty of the fiduciary to the beneficiary, demands absolute compliance, for

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<sup>3</sup> The eight other Circuit Court decisions that address the meaning of “defalcation” under clause (4) are cited in the opinion of the Circuit Court below. See *Bullock v. BankChampaign, N.A.*, 670 F.3d 1160, 1165-66 (11th Cir. 2012).

which honesty of purpose, mistake, or mere negligence, is not a defense. The other type, such as the fiduciary's duty to invest trust assets productively, calls for reasonable care, and is the basis for imposing personal liability on a fiduciary who, although having made an honest mistake, has performed negligently. In short, whether a debtor has defalcated turns on whether he or she has failed to comply with the standard of conduct required under the particular fiduciary duty imposed on him or her.

By sharp contrast, nine Circuit Courts, including the Circuit Court below, have failed to recognize that the particular fiduciary duty that has been breached itself fixes the level of conduct required by clause (4). Instead, those courts have concluded that, in order to decide whether a debtor has defalcated, it was necessary for them to consider various levels of misconduct, ranging from negligence to extreme recklessness, without regard to the standard of conduct required by the specific fiduciary duty that was breached, and then to choose one of those levels as the test for "defalcation." Each of these Circuit Courts thus selected a single level of culpability which, in its judgment, warranted nondischargability, and thereafter courts in that Circuit and some other Circuit Courts adopted that single standard as a universal standard for deciding whether the debtor defalcated under clause (4). Specifically, six of the Circuit Courts, including the Circuit Court below, ended up choosing some level of recklessness, while the other three Circuit Courts selected



a lesser standard.<sup>4</sup> In short, each Circuit has come up with its own “one size fits all” test. In the present case, the Circuit Court below chose “objective recklessness” as the standard for “defalcation.” In contrast, the *Amici* offer an analytical approach for determining under any state of facts whether a debtor has defalcated, which provides guidance needed by the lower courts not found in the opinions of the Circuit Courts that addressed the meaning of “defalcation” under clause (4).

The *Amici*’s suggested meaning of “defalcation” under clause (4) is based on several grounds. First, and most importantly, it is grounded on the fundamental historical purpose of the fiduciary defalcation provisions to protect the beneficiaries of specific trust funds, a goal which has never changed or been questioned. That purpose, which continues to underpin clause (4), reflects a strong public policy to ensure that trust beneficiaries, who rely heavily on their anticipated receipt of the trust fund, will ultimately receive the assets that have been placed in safekeeping for them. In light of the purpose of clause (4)’s defalcation provision, Congress must have intended to tether each fiduciary duty’s required standard of conduct to clause (4)’s defalcation provision, rather than having defalcation depend on a subjective judicial conclusion as to the level of misconduct thought to be sufficiently egregious to warrant nondischargability generally (i.e., in all cases).

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<sup>4</sup> The Circuit Court below grouped the eight other Circuit Court decisions according to the level of the debtor’s misconduct they selected as warranting nondischargability under clause (4). *Bullock*, 670 F.3d at 1165-1166.



Second, the *Amici's* approach is grounded on the jurisprudence of this Court. This Court's understanding of the first fiduciary defalcation provision, enacted as part of the Bankruptcy Act of 1841, strongly underpins the *Amici's* view of the meaning of "defalcation." In *Chapman v. Forsyth*, 43 U.S. 202, 208 (1844), this Court interpreted the fiduciary defalcation provision in the 1841 Bankruptcy Act as limited to certain types of fiduciaries, specifically trustees and estate executors and administrators who manage specific trust funds for specified beneficiaries. This limitation was based on the need to prevent trustees and similar fiduciaries from escaping liability for breaches of fiduciary duties by means of bankruptcy. In so holding, this Court observed that these fiduciaries are "special" fiduciaries who serve under what it called a "technical" trust, specifically holding that the fiduciary defalcation provision did not apply to trusts implied in law.

In the succeeding four major revisions of the bankruptcy statutes enacted after the 1841 Act was passed, including the 1978 revision, the wording of the fiduciary defalcation provisions changed so as to merge the named specific, or "special," fiduciaries into a single composite category making nondischargable debts arising from "defalcation while acting in a fiduciary capacity." These changes in wording were made without any indication, either in the text of the provisions or in legislative history, that Congress intended to eliminate (as opposed to supplement) its original understanding of "defalcation" as explained in *Chapman*. Nor do such word changes or their legislative history suggest that Congress intended to

depart from the understanding that making “defalcation” by a fiduciary nondischargable is the specific means to protect trust beneficiaries from the failure of trustees who serve under express trusts to comply with the standards of conduct established by the law of trusts.

Third, the *Amici*’s understanding of “defalcation” in clause (4) is further supported by its legislative history, which, in rejecting a specific recommendation in 1973 by a congressionally created bankruptcy review commission to eliminate a fiduciary defalcation provision altogether, continued to provide for a fiduciary defalcation provision in its 1978 enactment of clause (4).

Fourth, the *Amici* urge that grounding defalcation on the fiduciary’s failure to comply with the standard of conduct required by the particular fiduciary duty that has been breached, provides the appropriate measure of protection against a breach of each of the different types of fiduciary duties. Moreover, as this Court has explained, in the context of the 19 clauses of § 523(a) excepting various debts from the debtor’s discharge, clause (4) should be understood to reflect a congressional decision that the interest of the trust beneficiaries it protects outweighs the interest in a complete “fresh start” for a trustee who has breached his fiduciary duty to them.

In short, fidelity to clause (4) requires preserving a trust beneficiary’s right of recovery for a trustee’s breach of fiduciary duty by denying a free pass for the liability by means of bankruptcy.

## ARGUMENT

### POINT I

**THE FIDUCIARY DEFALCATION PROVISION OF § 523(a)(4) SHOULD BE INTERPRETED TO IMPLEMENT THE CONGRESSIONAL PURPOSE TO PROTECT BENEFICIARIES OF TRUST FUNDS FROM NONCOMPLIANCE BY TRUSTEES AND SIMILAR FIDUCIARIES WITH THE STANDARDS OF CONDUCT REQUIRED BY THE FIDUCIARY DUTIES IMPOSED BY THE LAW OF TRUSTS**

At its inception in the Bankruptcy Act of 1841, the fiduciary defalcation provision was enacted to protect trust fund beneficiaries from the failure of trustees and others who manage specific trust funds to comply with their fiduciary duties. "Defalcation," as understood by both Congress and this Court from the inception of defalcation provisions, depends upon whether there has been a breach of a fiduciary duty established by the non-bankruptcy law of trusts. For a court to decide whether there has been a breach of a fiduciary duty necessarily requires it to determine whether the fiduciary failed to comply with the standard of conduct required by such law for compliance with that duty. That standard of conduct thus inheres in a fiduciary defalcation provision.

The *Amici's* approach focuses on the various fiduciary duties and their required standards of conduct. The fiduciary duty of loyalty, and the fiduciary duty of due care in the administration of a trust fund, each provides its own standard for

compliance, the former requiring absolute compliance and the latter requiring reasonable care. Because Congress based defalcation provisions on the breach of fiduciary duties, the only plausible inference is that it intended that the standard required by the law of trusts for compliance with the particular fiduciary duty at issue would be the basis for determining whether a debtor defalcated. Congress essentially incorporated all segments of the law of trusts into its fiduciary defalcation provisions, not merely the portion of trust law imposing fiduciary duties while leaving behind the critically important portion establishing the standard of conduct required for compliance with them.

Congress thus looked to the law of trusts, an established body of state law, for the required standard of conduct for fiduciaries who control trust funds. This Court recognizes that Congress commonly bases its legislation on pre-existing state law. See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 544-545 (1994) (“[T]he Bankruptcy Code will be construed to adopt, rather than to displace, pre-existing state law.”); *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 740 (1979) (holding that, absent a congressional directive, state law governs the relative priority of federally held mortgages).

Congress provided no suggestion that it intended to leave it to a court to determine whether a debtor has defalcated on the basis of its own subjective judgment of what conduct it considers to be sufficiently egregious to warrant excepting a fiduciary’s debt from discharge. Accordingly, “defalcation” under clause (4) must



mean a failure of a debtor to comply with the standard of conduct under the law of trusts required by the particular fiduciary duty that he or she has breached.

#### **A. The Origin Of Fiduciary Defalcation Provisions**

The first defalcation provision, in the Bankruptcy Act of 1841, is rooted in an 1838 scandal of national proportions involving defalcation by an important official of the United States Treasury Department, Samuel Swartout. App. to the Cong. Globe, 25th Cong., 2nd Sess. 16 (December 1838). When it became known that Swartout, the New York Collector of Customs, which was the primary source of revenue for the United States Government, may have taken in excess of \$200,000 of customs duties to pay personal expenses, the Treasury Department conducted an audit, which revealed that the then massive sum of over \$1,300,000 of customs duties collected in the New York office could not be accounted for. The Secretary of the Treasury then prepared a special report on Swartout's defalcation, which President Martin Van Buren delivered to Congress with his own message dated December 8, 1838 calling for enactment of measures "for increasing the public security against similar defalcations hereafter." *Id.* The President's message to Congress repeatedly characterized Swartout's actions as "defalcation," *id.*, urging that Congress enact criminal penalties "against the loan or embezzlement of the public money by collectors, as well as all classes of officers, and the strictist prohibitions against its use in any way for private purposes." *Id.* at 18.

The nation's first bankruptcy statute, the Bankruptcy Act of 1800, had a life of only two years. Sufficient interest for enactment of another bankruptcy act developed some years later, resulting in passage of the Bankruptcy Act of 1841. Swartout's defalcation and the President's message of concern for defalcations was the focus of the legislators when including the first fiduciary defalcation provision in the 1841 Act. With the Swartout defalcation scandal fresh in their minds, the need to protect against defalcation by a fiduciary was appropriately reflected by the legislators in the 1841 legislation. In light of Swartout's defalcation, the 1841 defalcation provision understandably singled out "public officers" for special attention in the legislation in order to prevent public officers who failed to perform their fiduciary duties from escaping liability by means of a bankruptcy discharge.<sup>5</sup> Significantly, however, the

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<sup>5</sup> This appeal does not raise the issue whether clause (4) may be interpreted, as suggested by a few lower courts, to be applicable to fiduciaries such as corporate directors and officers, who are trustees under trusts that are implied in law and do not manage a specific trust *res* under an express trust. However, in connection with defining the scope and meaning of "defalcation" under clause (4), the *Amici* note their view that, under this Court's analysis of the defalcation provision at issue in *Chapman*, clause (4) should not be read as applicable to corporate directors and officers because their duties are not imposed by an express or technical trust that creates a trust *res* for a named beneficiary. In *Chapman*, this Court observed that it limited the application of the fiduciary defalcation clause so that it would not operate on debts arising from "commercial transactions," *Chapman*, 43 U.S. at 208, which indicates that a fiduciary defalcation provision is not intended to be applicable to corporate directors and officers or others who function in the commercial context and whose fiduciary duties are implied in law. It is also significant that, whereas each of the fiduciary defalcation pro-



1841 bankruptcy legislation went beyond the “public officer” defalcation segment of the provision. The legislators recognized that all fiduciaries who manage specific trust funds for beneficiaries, not only public officers, likewise required coverage in the defalcation provision in the advent of their bankruptcy filing. The 1841 defalcation provision thus covered “defalcation as a public officer; or as executor, administrator, guardian, or trustee, or while acting in any other fiduciary capacity.”<sup>6</sup>

In interpreting the original defalcation provision in *Chapman*, this Court held that the phrase “or while acting in any other fiduciary capacity”

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visions in the Bankruptcy Acts of 1841, 1867, 1898, and 1938 specifically included a “public officer” or “an officer,” clause (4) of the 1978 Bankruptcy Code omits “an officer” from its scope. The *Amici* further note that, even if the term “officer” under the earlier provisions had been intended to include corporate officers, Congress presumably did not, in view of this change in language, intend them to be covered by clause (4). See *Crawford v. Burke*, 195 U.S. 176, 190 (1904) (“[A] change in phraseology creates a presumption of a change in intent. . . .”). More recently, in *Commonwealth Land Title Co. v. Blaszk*, 397 F.3d 386, 391 (6th Cir. 2005), the court, in careful analysis, ruled that defalcation by a fiduciary under clause (4) requires “the existence of a pre-existing express or technical trust whose res encompasses the property at issue,” (citing *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 333 (1934)).

<sup>6</sup> The Bankruptcy Act of 1841, unlike its 1800 predecessor statute, authorized the voluntary commencement of a bankruptcy case. So as to prevent trustees and others who control trust funds to escape liability from a breach of fiduciary duty, Congress provided in Section 1 of the 1841 Act that such fiduciaries were not eligible to file in bankruptcy. 5 Stat. 440 (1841). The fiduciary defalcation provision in each of the subsequent Bankruptcy Acts, which permitted such fiduciaries to file in bankruptcy, provided that their debts arising from a breach of fiduciary duty were nondischargable.

was intended to cover only the same type of trusts as those specifically enumerated, namely those of trustees and others who manage specific trust funds for trust beneficiaries under technical trusts, not those implied in law. *Chapman*, 43 U.S. at 208. As stated by this Court, this limitation recognized that trustees and similar fiduciaries posed a special risk to the beneficiaries:

In almost all the commercial transactions of the country, confidence is reposed in the punctuality and integrity of the debtor, and a violation of these is, in a commercial sense, a disregard of trust. But this is not the relation spoken of in the first section of the act.

The cases enumerated, "the defalcation of a public officer," "executor," "administrator," "guardian," or "trustee," are not cases of implied but special trusts, and the "other fiduciary capacity" mentioned, must mean the same class of trusts.

*Id.* at 208.

From its inception, the purpose of fiduciary defalcation provisions has been to protect trust fund beneficiaries from a breach of fiduciary duty by a trustee and others in the special class of fiduciaries, who file in bankruptcy to shed liability for their breach. This Court reaffirmed its understanding of "defalcation," as expressed in *Chapman*, in each of its later decisions involving the fiduciary defalcation provisions of subsequent bankruptcy statutes. See *Neal v. Clark*, 95 U.S. 704, 708 (1877); *Hennequin v. Clews*, 111 U.S. 676, 679 (1884); *Upshur v. Briscoe*, 138 U.S. 365, 372

(1891); *Crawford*, 195 U.S. at 189; *Davis*, 293 U.S. at 333 (1934).

While courts interpreting the fiduciary defalcation provision of clause (4) often cite *Chapman*, they fail to recognize *Chapman's* understanding that "defalcation" is built on the non-bankruptcy law of trusts governing fiduciary duties, which provides the standards of conduct required for compliance. Accordingly, the result below should be affirmed on the ground that Petitioner, by self-dealing in violation of the duty of loyalty, breached the standard requiring absolute compliance with that fiduciary duty, as established by the law of trusts.

**B. Defalcation Consists Of Conduct That Fails To Comply With The Standard Required For Compliance With The Particular Fiduciary Duty That Has Been Breached**

The *Amici's* approach focuses on the fiduciary duty that has been breached and the standard of conduct required for compliance with it. The fiduciary duty of loyalty and the fiduciary duty of due care in the administration of a trust fund, each provides its own standard for compliance. One type of fiduciary duty requires strict compliance, whereas other types of fiduciary duties allow a measure of discretion.

**1. Types of Fiduciary Duties and Their Compliance Standards Under the Law of Trusts**

The law of trusts imposes two types of fiduciary duties. Whether a debtor has defalcated within the meaning of clause (4) turns on whether he or

she has failed to comply with the standard of conduct required for compliance with the particular fiduciary duty that has been breached.

One type of fiduciary duty, for example the duty requiring undivided loyalty, exacts the highest degree of loyalty, demanding that the fiduciary act solely in the interest of the beneficiary. It is no defense to a breach of such duty that the action was taken in good faith or honestly, or that the terms of the transaction were fair. Restatement (Third) of Trusts § 78, at 95, cmt. b (2007). The fiduciary duty of undivided loyalty “is particularly intense so that, in most circumstances, its prohibitions are absolute for prophylactic reasons. The rationale begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty.” *Id.* at 96. The only exceptions to the strict prohibitions of this duty involve transactions authorized by court order or by the terms of the trust instrument. *Id.* at 97. In this case, Petitioner placed his personal interests above those of the beneficiaries in taking self-dealing loans of trust funds, which, under the law of trusts, is not excused by his claim of good faith, and was not authorized by the trust agreement. The Petitioner’s self-dealing conduct in this case, in taking trust assets for personal use, constituted a *per se* defalcation under clause (4).

The other type of fiduciary duty imposed by the law of trusts involves the administration of trust funds, such as the fiduciary duty to invest trust funds productively. The law of trusts calls for a trustee to exercise reasonable care in the performance of such duty. 2A A. Scott, *The Law of*



Trusts § 170.25 (W.F. Frachter ed., 4th 2001). Negligent performance of that duty, though constituting an honest mistake, constitutes a breach of trust and thus defalcation.

The difference between the two types of duties imposed by the law of trusts and the standards of conduct they require for compliance, is well illustrated by *Dickerson v. Camden Trust Co.*, 53 A.2d 225 (N.J. Ch. 1947). In that case, the court surcharged an executor for losses in "non-legal" securities retained in the estate by the executor in contravention of a provision of the will. It was held that this provision of the will did not allow for any exercise of discretion because noncompliance with a provision of the trust instrument violates the fiduciary duty of loyalty, which imposes an absolute obligation to comply with the instrument. The court went on to hold that the breach of the duty of loyalty was not excused by the fact that the executor "may have acted in perfect good faith" in attempting to generate sufficient income to meet the testator's objective. *Id.* at 231. By contrast, as noted by the court, the executor would be afforded a reasonable time to dispose of securities in compliance with such direction, and also would have been under a duty to exercise "good faith and reasonable discretion" in retaining "non-legal" securities in the absence of the direction by the will to dispose of them. *Id.* at 237. The court thus focused on the particular standard of conduct required for compliance with the fiduciary duty that has been breached, rather than on a degree of fault that the court believed warranted the imposition of a surcharge. On appeal, the surcharge order in *Dickerson* was affirmed by the New Jersey Supreme Court. *Dickerson v. Camden Trust*

Co., 64 A.2d 214, 217 (N.J. 1949) (per Arthur T. Vanderbilt, C.J.) (stating that where action taken by the fiduciary is not authorized by the trust instrument, the breach of a fiduciary duty is not excused by "the exercise of reasonable care and discretion in good faith"). *Accord Gilbert v. Kolb*, 37 A. 423 (Md. 1897) (stating that acts not permitted by the trust instrument, though "done in the utmost good faith," constitute a breach of fiduciary duty, while an exercise of discretionary authority constitutes a breach of fiduciary duty if the trustee fails to act "in good faith and with diligence"). *See also* Bogert's Trusts and Trustees § 541 at 161-162 ("Any attempt to take action contrary to the settlor's directions may be deemed to constitute a unilateral and invalid deviation from the trust terms though the trustee is otherwise given broad discretions in administering the trust.")

In surcharging a bankruptcy reorganization trustee for profits earned by his employees in trading outstanding securities of the debtor company, this Court, in *Mosser v. Darrow*, 341 U.S. 267, 275 (1951), refused to entertain as a defense that the trustee had no personal interest in his employees' profits and acted in good faith. Significantly, this Court reversed the decision of the lower court denying a surcharge because that decision was based on the fact that the trustee's conduct was merely negligent. In holding the trustee responsible, this Court stated that in a strict trusteeship, "[e]quity tolerates in bankruptcy trustees no interest adverse to the trust," explaining that "[t]his is not because such interests are always corrupt but because they are always corrupting." *Id.* at 271. For this reason, a



trustee is under an absolute obligation to comply with the fiduciary duty of loyalty, because "strict adherence" to the duty of loyalty will ensure compliance with the high standard it requires for performance of that paramount duty. See *Woods v. City Nat. Bank & Trust Co. of Chicago*, 312 U.S. 262, 269 (1941), quoting *Meinhard v. Salmon*, 249 N.Y. 458, 464 (1928) ("Only strict adherence to these equitable principles can keep the standard of conduct for fiduciaries 'at a level higher than that trodden by the crowd.'").

The diversion of trust funds for use for a trustee's own business purposes thus constitutes a clear breach of the fiduciary duty of undivided loyalty and constitutes defalcation under the fiduciary defalcation provision, even assuming *arguendo* that the default was innocent. This reflects the basic rule under the law of trusts that a trustee's use of trust money to make personal investments constitutes a breach of the fiduciary duty of loyalty, to which there is no defense. See *Whitaker v. Estate of Whitaker*, 663 N.E.2d 681, 685 (Ohio Ct. App. 1995) (surcharging an executor for self-dealing consisting of borrowing from the trust fund); *Feinberg v. Adolph K. Feinberg Hotel Trust*, 922 S.W.2d 21, 25-26 (Mo. Ct. App. 1996) (same).

## **2. Petitioner Wrongly Urges Fraud, Embezzlement and Larceny as the Standard Under Clause (4), and Misapplies the Canon, *Noscitur a Sociis***

Petitioner asserts that a debt cannot be nondischargeable under clause (4) unless it arises from "the degree of culpability commensurate with

fraud, embezzlement, and larceny." Pet. Br. 7, 23. There is, however, no basis in the text or legislative history of clause (4) for finding congressional intent to limit defalcation to serious criminal conduct "involving moral turpitude or intentional wrong," which are the hallmarks of fraud and embezzlement. See *Neal*, 95 U.S. at 709; *Noble v. Hammond*, 129 U.S. 65, 69 (1889) (stating "moral turpitude or intentional wrong" is required to be nondischargable as "fraud" or "misappropriation").

Moreover, using "moral turpitude or intentional wrong" as the standard for defalcation would render the fiduciary defalcation provision meaningless, as covering nothing other than what is already covered by the fraud, embezzlement and larceny. As stated by Judge Learned Hand in *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 511 (1937), "defalcation" must cover something other than "fraud or embezzlement."

Nor does clause (4) require willful misconduct for defalcation, as Petitioner contends. Pet. Br. 21-23. Clause (4) does not mention willfulness as the standard of conduct for defalcation, which is required by § 523(a)(6) to render nondischargable an injury to another person or property. It would make no sense to interpret clause (4) as requiring willful conduct in light of Congress' use of that word in providing for nondischargability in clause (6) and not in clause (4). As stated in *BFP v. Resolution Trust Co.*, 511 U.S. 531, 538 (1994): "It is generally presumed that Congress acts intentionally and purposely when it includes particular language in one section of a statute but omits it in another." (quoting *City of Chicago v. Env'tl. Def. Fund*, 511 U.S. 328, 338 (1994)).

Petitioner also relies heavily on the interpretive canon, *noscitur a sociis*. Pet. Br. 21-23. His reliance on that canon, however, is misplaced. "Defalcation" occurs in clause (4) directly in connection with the words "fiduciary capacity," and it is to those immediate specific word "companions" (what the Latin word "*sociis*" refers to) to which one must turn to construe "defalcation" and not to the remote companions "fraud," "embezzlement," or "larceny," as Petitioner contends.

### **3. Negligent Conduct Constitutes Defalcation When Reasonable Care is the Applicable Standard of Conduct Under the Law of Trusts**

The *Amici* recognize that, whereas many debts incurred by debtors as a result of negligent conduct are discharged by bankruptcy, under their approach the debt of a fiduciary for negligent conduct in breach of a fiduciary duty requiring reasonable care would be nondischargeable under clause (4). This is best understood in light of the special duty that a trustee owes to the beneficiary, and the design of the fiduciary defalcation provision to hold a fiduciary to the standard of conduct fixed by the law of trusts. Moreover, from the point of view of the beneficiary, which is the focus of clause (4), not that of the debtor, the injury to be guarded against is no less hurtful to the beneficiary where the fiduciary's conduct constitutes negligence rather than of a more egregious level.

Several Circuit Courts have recognized that negligent misdeeds, though innocent, constitute defalcation under clause (4), although their opinions likewise lack an analytical basis for their cho-

sen standard. See *In re Uwimana*, 274 F.3d 806, 811 (9th Cir. 2001); *In re Sherman*, 658 F.3d 1009, 1014 (9th Cir. 2011); *In re Cochrane*, 124 F.3d 978, 984 (8th Cir. 1997).

In this connection, the *Amici* note that, contrary to Petitioner's contention, this Court's opinion in *Kawaauhau v. Geiger*, 523 U.S. 57 (1998), sheds no light on the meaning of "defalcation" in clause (4). *Geiger* held that a debtor's debt arising from negligence was nondischargeable under clause (6) of § 523(a) because it did not arise from a "willful and malicious injury" as required by clause (6). *Id.* at 63-64. *Geiger*, however, does not bear on the meaning of defalcation under clause (4) because, although its opinion discussed several other clauses of § 523(a), *Geiger* did not involve clause (4) and its opinion did not discuss or even cite clause (4) once. Petitioner's reliance on *Geiger* illuminates his failure to understand that, in enacting clause (4), Congress determined as a matter of policy that the bankruptcy of a trustee or similar fiduciary should not preclude trust beneficiaries from pursuing all remedies to collect the trust funds placed in safekeeping for them. Clause (4)'s purpose to fully protect trust beneficiaries can be fulfilled only if a trustee's debts for breach of fiduciary duty, whether arising from intentional or negligent conduct, survive a bankruptcy.

#### **4. Judge Learned Hand's Opinion in *Herbst* Illuminates that Fiduciary Duties Are Inherent in Clause (4)**

Many courts have looked to Judge Learned Hand's opinion in *Herbst* to find a test for defalcation under a fiduciary defalcation provision in the



bankruptcy law, or for a pathway to an understanding of its meaning.<sup>7</sup> Although some Circuit Courts have viewed *Herbst* merely as a “carefully equivocal opinion,” *In re Patel*, 565 F.3d at 970; *In re Baylis*, 313 F.3d at 18, *Herbst* indeed offers insight into what Congress meant by defalcation. The *Amici* read Judge Hand’s opinion as reflecting his understanding that defalcation consists of a violation of a fiduciary duty imposed by the law of trusts, and that where, as in *Herbst*, the particular fiduciary duty requires absolute compliance, a breach of that duty constitutes defalcation, which is not excused by good faith or the honesty of a mistake.

In that case, Judge Hand explored defalcation in terms of levels of a debtor’s misconduct, indicating that some measure of wrongdoing is required.<sup>8</sup> Although Judge Hand did not articulate a concrete test for what constitutes defalcation, the *Amici* suggest that the significance of his opinion is found in his understanding that defalcation is

<sup>7</sup> See *Bullock*, 670 F.3d at 1164, where the Circuit Court below described *Herbst* “as containing ‘perhaps the best’ analysis of the meaning of ‘defalcation’ under § 523(a)(4)” (citing *Quaif v. Johnson*, 4 F.3d 950, 955 (11th Cir. 1993), and noting that *Herbst* addressed the predecessor statute). The following Circuit Court decisions referred to in the opinion of the Circuit Court below also cited *Herbst* in addressing the meaning of “defalcation” under § 523(a)(4): *In re Patel*, 565 F.3d 963, 970 (2009); *In re Baylis*, 313 F.3d 9, 18 (1st Cir. 2002); *In re Hyman*, 502 F.3d 61, 69 (2d Cir. 2007); *In re Berman*, 629 F.3d 761, 766 (7th Cir. 2011).

<sup>8</sup> The current edition of Collier on Bankruptcy merely cites *Herbst* without any discussion or comment, and cites many cases applying clause (4) without setting forth the meaning of “defalcation.” See 16 Collier on Bankruptcy ¶ 523.10[1][d] at p. 523-75 and n 37 (16th ed. 2012).

dependent upon there having been a breach of a fiduciary duty. *Herbst*, 93 F.2d at 512. The concept that for there to be a defalcation there must be a breach of a fiduciary duty is at the core of the *Amici's* understanding of what Congress meant by defalcation, which the Circuit Courts addressing clause (4) have overlooked. Although Judge Hand did not directly state that the standards of conduct required by the various fiduciary duties are built into the fiduciary defalcation provisions enacted by Congress, the conclusion that defalcation means noncompliance with those standards of conduct is a necessary inference from his holding.

In *Herbst*, the debtor, a non-lawyer, was a dentist who was appointed as a foreclosure receiver to handle a trust fund consisting of the proceeds from the sale at foreclosure of the mortgaged property. The foreclosure court's order awarded the debtor a fee for his service as foreclosure receiver, which he took from the trust fund. Although the debtor was authorized by court order to take his fee from the trust fund, the order was later reversed, by which time he had become insolvent without having returned the funds and filed for bankruptcy relief. The debtor thus placed his self-interest in getting paid ahead of his fiduciary duty to maintain the trust fund solely for the beneficiary's benefit, in that case the foreclosing mortgagee. Judge Hand ruled that the debtor's defalcation consisted of his failure to return trust funds, which, although lawfully taken pursuant to a court order, he had no right to keep and had an absolute fiduciary duty to return when the order was later reversed.

*Herbst* should thus be read as ruling that defalcation means noncompliance by the debtor with



the standard of conduct required by the fiduciary duty that has been breached, in that case the duty of undivided loyalty, which was held to impose an absolute duty on the debtor to return trust funds he had no legal right to retain. In so holding, Judge Hand rejected as defenses to the debtor's defalcation that his taking of the fee was permitted by a court order at the time of the taking, and that, as a non-lawyer, he should not be charged with knowledge of the law or be required to anticipate that a court order might be reversed. The debtor's defalcation in *Herbst* occurred when he failed to return trust funds he had no right to keep, for which the law accepted no excuse. Likewise, in the present case, the debtor's self-dealing use of trust funds constituted defalcation at the moment of the taking, for which the law of trusts does not accept as defenses his claims of good faith and honest intentions, including the later return of the money, though without the profit he now seeks to keep for himself.

The *Amici's* understanding of defalcation is thus illuminated by the opinion in *Herbst*, which supports the holding of the Circuit Court below that the debtor's self-dealing borrowing of trust funds constituted defalcation under clause (4).

*In re Baylis*, upon which Petitioner relies, likewise pronounced that defalcation under clause (4) is based on the breach of a fiduciary duty:

Inherent in 'defalcation' is the requirement that there be a breach of fiduciary duty; if there is no breach, there is no defalcation.

*Baylis*, 313 F.3d at 17.

*Baylis* went on to recognize that there are two types of fiduciary duties, each with a different standard of conduct required for compliance, with the duty of loyalty requiring absolute compliance, and other fiduciary duties requiring reasonable care. In analyzing the non-bankruptcy law of trusts, the court in *Baylis*, quoting 2A A. Scott, *The Law of Trusts* § 170.25 (W.F. Frachter ed. 4th 2001), stated:

In evaluating whether there is a defalcation of a fiduciary duty, there must be reference to the duty involved.

\*\*\*\*\*

As long as [a trustee] is not acting in his own interest the standard fixed for his behavior is only that of a reasonable degree of care, skill and caution. But when the trustee acts in his own interest in connection with the performance of his duties as trustee, the standard of behavior becomes more rigorous. In such a case his interest must yield to that of the beneficiaries.

2A *id.* § 170.25. As with the other fault-based exceptions, fault may be presumed from the circumstances, here a violation of the duty of loyalty.

*Baylis*, 313 F.3d at 20-21

Significantly, however, in the face of these principles of the law of trusts it considered to be essential to determining whether a debtor defalcated, the court in *Baylis* chose "extreme recklessness," *id.* at 22-23, as a sufficiently egregious

singular standard coming close enough to that required for fraud, embezzlement and larceny to constitute defalcation. *Id.* at 19-20. The court in *Baylis* then applied its "extreme recklessness" standard of conduct both to the duty of loyalty, which requires absolute compliance, and to the duty to use reasonable care in the sale of trust property to a third party, which it held excuses conduct that is "not so reckless as to rise to the level of fault needed to constitute a defalcation." *Id.* at 23.

*Baylis* got it wrong. It referred to nondischargability of various debts under other clauses of § 523(a) as precluding the use of bankruptcy to nullify certain types of debts, "the repayment of which are important for policy reasons," and as to which "[t]he level of fault of the debtor has no bearing." *Id.* at 19. It is beyond comprehension, however, that the court in *Baylis* did not see clause (4)'s specification of defalcation as based on policy reasons, while at the same time recognizing that Congress singled out, as based on policy reasons warranting nondischargability, debts based on non-payment of taxes, alimony, and educational loans, among others. Without explanation or citation to *Chapman*, *Baylis* merely asserted that it was "unlikely" to read clause (4) as reflecting Congressional intent "to reinforce the high standard of care owed by fiduciaries by making debts for defalcation non-dischargeable." *Id.* at 19. In reaching its understanding of defalcation, *Baylis*, like many courts in search of the meaning of defalcation, cited *Herbst* for the notion that "[d]efalcation is to be measured objectively," *id.* at 17, but nevertheless chose to measure it according

to its own subjective judgment as to the level of misconduct that warrants nondischargability.

**C. Clause (4)'s Legislative History Indicates That Defalcation Means Noncompliance With The Standard Fixed By The Particular Fiduciary Duty In Question**

Petitioner's test for defalcation under § 523(a) (4) based on "culpability commensurate with fraud, embezzlement and larceny," Pet. Br. 7, 23, would require a finding of "fraudulent intent" reflective of "moral turpitude or intentional wrong" akin to criminal intent. Such reading of cause (4) lacks any support in its text or legislative history, and would make defalcation merely duplicative of the other clause (4) grounds for nondischargability, reading it out of the statute.

The original fiduciary defalcation provision, enacted in 1841, was limited to "a defalcation as a public officer; or as executor, administrator, guardian or trustee, or while acting in any other fiduciary capacity," without mentioning fraud or embezzlement. Ch. 9, 5 Stat. 440 § 1 (1841). The bankruptcy amendments of 1867 introduced fraud and embezzlement as a basis for nondischargability, declaring such intentional conduct to be nondischargable without regard to whether the debtor was acting in a fiduciary capacity. The 1867 Act used the following words: "[N]o debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged. . . ." Ch. 176, 14 Stat. 517 § 33 (1867). As made clear by Judge Hand in *Herbst*, "defalcation" in the 1867 version did not gain meaning from Congress' addition of "fraud" and "embezzle-



ment." *Herbst*, 93 F.2d at 511. As he stated: "Whatever was the original meaning of 'defalcation,' it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement.'" *Id.* Petitioner's reliance on "fraud" and "embezzlement" as the standard for "defalcation" flies in the face of *Herbst*.

Thereafter, in enacting §17a(4) of the Bankruptcy Act of 1898, Congress amended the fiduciary defalcation provision to tie fraud, embezzlement, and misappropriation to activity in a fiduciary capacity, not as independent bases for nondischargability, as under the 1867 statute. Ch. 541, 30 Stat. 544 § 17 (1898). The 1898 provision continued to make nondischargable debts for "defalcation while acting as an officer or in any fiduciary capacity." Congress' purpose in 1898 in also rendering nondischargable debts created by "fraud while acting in any fiduciary capacity" is unclear, given that prior to the amendment of that provision in 1903 non-fiduciary debts based on fraud were not made nondischargable, and the language of the 1898 provision does not suggest that defalcation was intended to be based on the intentionally wrongful intent required to establish fraud.

Nor does the minor change in the version of the fiduciary defalcation provision enacted in the Bankruptcy Act of 1938 shed any light on what Congress intended defalcation to mean. The 1938 provision rendered nondischargable debts of the debtor "created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity," using the exact language of the 1898 provision, except for its



omission of a comma after the word "misappropriation," a change for which its meaning is unclear. Ch. 575, 52 Stat. 840 § 17 (1938).

While the subject of fiduciary defalcation received a measure of attention during the legislative process in the 1970s, which led to the enactment of clause (4) in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598 (1978), Congress left the courts wondering what it meant by defalcation by a fiduciary. No pattern or understanding of it emerges from the text of clause (4) or its legislative history. The enactment of clause (4) came about after the congressionally-created Commission on the Bankruptcy Laws of the United States filed its 1973 report, which included a draft that would have only excepted from a discharge "any liability for embezzlement or larceny," without a provision for nondischargability of debts arising from "defalcation" or "misappropriation," which it stated to be "overbroad and uncertain in meaning." See Commission Report, H.R.Doc. No. 93-137, Pt. 2, at 136 n 139 (1973).

Adopting the recommendation of the 1973 Commission Report to jettison the fiduciary defalcation provision of the prior Bankruptcy Acts, a bill introduced in the House in 1977 would have limited nondischargability to debts for "embezzlement or larceny," without providing for nondischargability of debts for "defalcation." Petitioner's brief, however, wrongly asserts that Congress relied on the Commission Report, Pet. Br. 14 n.3, failing to tell this Court that Congress rejected the House's bill. The Senate responded to the House's bill, providing in its own bill that nondischargability under clause (4) would consist of "defalcation" without connecting it to fiduciary

capacity, as well as fraud while acting in a fiduciary capacity, embezzlement, and misappropriation. See S.Rep. No. 95-989 at 79 (1978) ("Paragraph (4) excepts debts for fraud incurred by the debtor while acting in a fiduciary capacity or for defalcation, embezzlement, or misappropriation."). The final version of clause (4), as enacted, was a compromise between the Senate and House versions, and lacked any legislative explanation of its ultimate wording. See *Estate of Neilson v. Simpson*, 37 B.R. 132, 135-136 (Bankr. D. N.H. 1984) (reviewing the legislative history of clause (4), and holding that a debtor's debt for self-dealing, akin to the debtor's debt in *Herbst*, constituted defalcation). See also floor statements by Congressman Edwards, 124 Cong. Rec. H32,399 (daily ed. Sept. 28, 1978) (stating that § 523(a)(4) represents a compromise between the House version and the Senate bill) and by Senator DeConcini, 124 Cong. Rec. S33,998 (daily ed. Oct. 5, 1978) (same). For clause (4), as enacted, Congress included the House's standard of "embezzlement or larceny," adopted the Senate's standard of "fraud while acting in a fiduciary capacity," and added back "defalcation while acting in a fiduciary capacity," which latter element was introduced by the 1841 Act and had been among the nondischargability provisions in each of the subsequent Bankruptcy Acts. It is understandable why the Circuit Courts had difficulty in interpreting clause (4).

Petitioner's *Amicus* patently misleads this Court regarding clause (4)'s legislative history by his quotation from H. Rep. No. 95-595, at 364 (1977). That Report discussed the House's proposed

nondischargability provision that, if it had been enacted, would have only excepted from discharge debts for embezzlement or larceny, without any provision for excepting debts for fiduciary defalcation. In his brief, Petitioner's *Amicus* asserts that the 1977 House Report establishes that the intent of clause (4) is that a fiduciary's borrowing of trust funds is nondischargable as a defalcation only if the debtor acted "willfully and maliciously," and that there can be no defalcation if the debtor "acted without malicious intent." Pet'r's *Amicus* Br. 28. Petitioner's *Amicus*, however, failed to tell this Court that the House's version of its nondischargability provision was not enacted and that its Report did not deal with or even mention fiduciary defalcation, each a critical point making that Report utterly irrelevant to the meaning of defalcation, which could not have escaped from the attention of Petitioner's *Amicus*. Nor did he mention that the House's bill discussed in its Report was at odds with the fact that every prior bankruptcy act, commencing with 1841, included a fiduciary defalcation provision, which the House would have jettisoned. His attempt to squeeze out of the House Report an intent by Congress to require for defalcation "malfeasance" by a debtor consisting of "willful and malicious" conduct, is misleading and misguided.

The Congressional notion of fiduciary defalcation was rooted at its inception in the non-bankruptcy law of trusts. Congress has given no hint in its text or legislative history, or during any of the four amendatory opportunities it had (in 1867, 1898, 1938, and 1978) after the original enactment in 1841, that it intended a new and dif-

ferent meaning for defalcation than had emerged from *Chapman*. See *Midlantic Nat. Bank v. New Jersey Dep't of Env'tl. Prot.*, 474 U.S. 494, 500-501 (1986) (relying on a "judicially created doctrine," stating that "[t]he normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific."); *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (stating that "to effect a major change [requires] at least some discussion in the legislative history."); *BFP*, 511 U.S. at 544-545 ("[T]he Bankruptcy Code will be construed to adopt, rather than displace, pre-existing state law.").

## POINT II

### **CONGRESS AND THIS COURT DETERMINED THAT THE INTERESTS OF TRUST BENEFICIARIES PROTECTED UNDER § 523(a)(4) ARE PARAMOUNT TO A DEBTOR'S "FRESH START"**

Section 523(a)'s exception of particular debts from the broad scope of a debtor's discharge in bankruptcy implements Congress' conclusion that the interests of those persons for whom it determined to provide protection under its nondischargeability provisions are stronger than the interests of debtors in gaining a "fresh start" through bankruptcy. Clause (4)'s meaning is not guided by the "fresh start" policy of the Bankruptcy Code, which denies a refuge to a debtor who has breached a fiduciary duty by failing to comply with the standard of conduct required by the law



of trusts for compliance with such duty. In interpreting the meaning of defalcation under clause (4), however, the Circuit Courts, in searching for the meaning of defalcation, failed to implement Congress' concept of § 523(a), the focus of which is on the injury to those harmed by the debtor's misconduct, not on the debtor who is seeking to escape liability through bankruptcy for his breach of fiduciary duty.

In *Grogan v. Garner*, 498 U.S. 279, 287-288 (1991), this Court, in determining the applicable burden of proof in § 523(a) litigation, explained that in the nondischargability context, the interests of those protected under each of the clauses of § 523(a) take precedence over the "fresh start" policy of the Bankruptcy Code. As stated by this Court in *Grogan* in explaining Congress' approach to nondischargability: "[T]he creditors' interest in recovering full payment of debts in these categories [of § 523(a)] outweigh[s] the debtors' interest in complete fresh start." *Id.* at 287. This Court thus rejected the lower court's reliance on the principle that "the general 'fresh start' policy that undergirds the Bankruptcy Code militated in favor of a broad construction favorable to the debtor." *Id.* at 283. Accord *Cohen v. De La Cruz*, 523 U.S. 213, 222 (1998) ("The various exceptions to discharge in § 523(a) reflect a conclusion on the part of Congress 'that the creditors' interest in recovering full payment of debts in these categories outweigh[s] the debtors' interest in a complete fresh start.'" (quoting *Grogan*, 498 U.S. at 287)). In other circumstances, this Court, as in *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365 (2007), has likewise limited a debtor's



right to a “fresh start” based upon his or her misconduct.

Despite the inapplicability of the “fresh start” policy to a determination of what constitutes defalcation under clause (4), the Circuit Court below, and the other Circuit Courts upon whose opinions it relied, drew upon that policy in reaching the conclusion that defalcation means conduct that violates a heightened standard of recklessness consisting of “extreme recklessness,” “objective recklessness,” or plain “recklessness.” See *Bullock*, 570 F.3d at 1164; *In re Hyman*, 502 F.3d at 66; *In re Baylis*, 313 F.3d at 18; *In re Berman*, 629 F.3d at 765; *In re Harwood*, 637 F.3d 615, 619 (5th Cir. 2011).

In the present case, the Circuit Court below erroneously proceeded on the basis that “[a] central purpose of the Bankruptcy Code is to provide an opportunity for certain insolvent debtors to discharge their debts and enjoy a fresh start.” *Bullock*, 670 F.3d at 1164. It thus saw the issue with the wrong focus, relying on the “fresh start” goal, rather than on the injury to trust beneficiaries, to whom Congress granted special protection under clause (4). Moreover, in the present case, that goal should not have been applied to protect the debtor, who, as a trustee of other persons’ money, could not resist the temptation to use it for his own benefit.

## **CONCLUSION**

Based on the foregoing, the order appealed from should be affirmed upon the grounds urged herein, rather than upon those in the opinion below.

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**AMICUS  
CURIAE  
BRIEF**

RECORD  
AND  
BRIEFS

No. 11-1518

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IN THE  
**Supreme Court of the United States**

RANDY CURTIS BULLOCK,

*Petitioner,*

v.

BANKCHAMPAIGN, N.A.,

*Respondent.*

ON WRIT OF CERTIORARI TO THE  
UNITED STATES COURT OF APPEALS  
FOR THE ELEVENTH CIRCUIT

**BRIEF OF *AMICUS CURIAE*  
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IN SUPPORT OF PETITIONER**

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**TABLE OF CONTENTS**

|                                                                                                                                                                                                      | <i>Page</i> |
|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|
| TABLE OF CONTENTS.....                                                                                                                                                                               | <i>i</i>    |
| TABLE OF AUTHORITIES .....                                                                                                                                                                           | <i>iii</i>  |
| INTEREST OF THE <i>AMICUS CURIAE</i> .....                                                                                                                                                           | 1           |
| STATEMENT .....                                                                                                                                                                                      | 4           |
| SUMMARY OF THE ARGUMENT .....                                                                                                                                                                        | 6           |
| ARGUMENT .....                                                                                                                                                                                       | 10          |
| A. The Court Should Construe the<br>“Defalcation” Exception Narrowly.....                                                                                                                            | 10          |
| 1. The Court Should Construe the<br>Exceptions to the Discharge<br>Narrowly to Effectuate the<br>Bankruptcy Code’s Fresh Start<br>Policy .....                                                       | 12          |
| 2. The Court’s Approach of<br>Interpreting Narrowly the<br>Exceptions to Discharge<br>Parallels Its Approach of<br>Interpreting Narrowly the<br>Exceptions to the Code’s Priority<br>Provisions..... | 14          |



**TABLE OF CONTENTS**  
(continued)

|                                                                                                                                                                                                                                           | <i>Page</i> |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------|
| B. Congress Intended to Limit the Term "Defalcation" in Section 523(a)(4) to Debts Arising from a Debtor's Serious Malfeasance .....                                                                                                      | 18          |
| C. The First and Second Circuits' Conclusion that "Defalcation" Exists Only When the Debtor's Behavior Rises to the Level of Extreme Recklessness Is the Most Faithful to the Language, Structure, and History of Section 523(a)(4) ..... | 27          |
| CONCLUSION .....                                                                                                                                                                                                                          | 34          |

# TABLE OF AUTHORITIES

|                                                                                                                            | <i>Page</i>    |
|----------------------------------------------------------------------------------------------------------------------------|----------------|
| <b>CASES</b>                                                                                                               |                |
| <i>Angelle v. Reed (In re Angelle),</i><br>610 F.2d 1335 (5th Cir. 1980) .....                                             | 28             |
| <i>Beecham v. United States,</i><br>511 U.S. 368 (1994) .....                                                              | 20             |
| <i>Buchanan v. Smith,</i><br>83 U.S. 277 (1872) .....                                                                      | 15             |
| <i>Central Hanover Bank &amp; Trust</i><br><i>Co. v. Herbst,</i><br>93 F.2d 510 (2d Cir. 1937)<br>(Learned Hand, J.) ..... | 29, 30, 31, 32 |
| <i>Crawford v. Burke,</i><br>195 U.S. 176 (1904) .....                                                                     | 27             |
| <i>Davis v. Aetna Acceptance Co.,</i><br>293 U.S. 328 (1934) (Cardozo, J.) .....                                           | 27             |
| <i>Denton v. Hyman (In re Hyman),</i><br>502 F.3d 61 (2d Cir. 2007) .....                                                  | <i>passim</i>  |
| <i>FCC v. NextWave Personal Commc'ns Inc.,</i><br>537 U.S. 293 (2003) .....                                                | 12             |
| <i>Gleason v. Thaw,</i><br>236 U.S. 558 (1915) .....                                                                       | 14, 18         |

**TABLE OF AUTHORITIES**  
(continued)

|                                                                                                         | <i>Page</i> |
|---------------------------------------------------------------------------------------------------------|-------------|
| <i>Gustafson v. Alloyd Co.</i> ,<br>513 U.S. 561 (1995) .....                                           | 19, 20      |
| <i>Hamilton v. Lanning</i> ,<br>130 S. Ct. 2464 (2010) .....                                            | 23          |
| <i>Hickman v. Texas</i> ,<br>260 F.3d 400 (5th Cir. 2001) .....                                         | 21          |
| <i>Howard Delivery Serv., Inc. v. Zurich</i><br><i>American Ins. Co.</i> ,<br>547 U.S. 651 (2006) ..... | 15, 16      |
| <i>Jarecki v. G.D. Searle &amp; Co.</i> ,<br>367 U.S. 303 (1961) .....                                  | 20          |
| <i>Kawaauhau v. Geiger</i> ,<br>523 U.S. 57 (1998) .....                                                | 14          |
| <i>Keime v. Graff</i> ,<br>14 F. Cas. 218 (C.C.W.D. Pa. 1878) ..                                        | 8, 24, 29   |
| <i>Kothe v. R.C. Taylor Trust</i> ,<br>280 U.S. 224 (1930) .....                                        | 16          |
| <i>Lamie v. U.S. Trustee</i> ,<br>540 U.S. 526 (2004) .....                                             | 23          |
| <i>Local Loan Co. v. Hunt</i> ,<br>292 U.S. 234 (1934) .....                                            | 13          |

# TABLE OF AUTHORITIES

(continued)

|                                                                                                                    | <i>Page</i>   |
|--------------------------------------------------------------------------------------------------------------------|---------------|
| <i>Louisville Joint Stock Land<br/>Bank v. Radford,</i><br>295 U.S. 555 (1935) .....                               | 17            |
| <i>Nathanson v. NLRB,</i><br>344 U.S. 25 (1952) .....                                                              | 16            |
| <i>Neal v. Clark,</i><br>95 U.S. 704 (1887) .....                                                                  | 25, 26        |
| <i>Renwick v. Bennett (In re Bennett),</i><br>298 F.3d 1059 (9th Cir. 2002) .....                                  | 13            |
| <i>Rutanen v. Baylis (In re Baylis),</i><br>313 F.3d 9 (1st Cir. 2002) .....                                       | <i>passim</i> |
| <i>Stellwagen v. Clum,</i><br>245 U.S. 605 (1918) .....                                                            | 17            |
| <i>Travelers Cas. &amp; Surety Co. of America v.<br/>Pacific Gas &amp; Elec. Co.,</i><br>549 U.S. 443 (2007) ..... | 23            |
| <i>Tsurukawa v. Nikon Precision, Inc.<br/>(In re Tsurukawa),</i><br>258 B.R. 192 (B.A.P. 9th Cir. 2001) .....      | 26            |
| <i>Union Bank v. Wolas,</i><br>502 U.S. 151 (1991) .....                                                           | 15            |

# TABLE OF AUTHORITIES

(continued)

|                                                                         | <i>Page</i>        |
|-------------------------------------------------------------------------|--------------------|
| <i>United States v. Ron Pair Enters.</i> ,<br>489 U.S. 235 (1989) ..... | 18                 |
| <i>Young v. Higbee Co.</i> ,<br>324 U.S. 204 (1945) .....               | 15                 |
| <br><b>STATUTES</b>                                                     |                    |
| 11 U.S.C. § 507 .....                                                   | 15                 |
| 11 U.S.C. § 523 .....                                                   | 3, 12, 18          |
| 11 U.S.C. § 523(a) .....                                                | 19, 21, 26, 29, 32 |
| 11 U.S.C. § 523(a)(2) .....                                             | 22, 28             |
| 11 U.S.C. § 523(a)(4) .....                                             | <i>passim</i>      |
| 11 U.S.C. § 523(a)(6) .....                                             | 22                 |
| 11 U.S.C. § 523(a)(7) .....                                             | 21                 |
| 11 U.S.C. § 523(a)(9) .....                                             | 8, 22              |
| 11 U.S.C. § 523(a)(12) .....                                            | 22                 |
| 11 U.S.C. § 524(a) .....                                                | 12                 |
| 11 U.S.C. § 524(c) .....                                                | 12                 |
| 11 U.S.C. § 524(c)(3)(B) .....                                          | 13                 |



# TABLE OF AUTHORITIES

(continued)

*Page*

|                                                                                |    |
|--------------------------------------------------------------------------------|----|
| Act of July 1, 1898, ch. 541, § 17(4),<br>30 Stat. 550-51 (repealed 1978)..... | 28 |
|--------------------------------------------------------------------------------|----|

## OTHER AUTHORITIES

|                                                                                             |            |
|---------------------------------------------------------------------------------------------|------------|
| 4 COLLIER ON BANKRUPTCY ¶ 507.01<br>(16th ed. 2012).....                                    | 16         |
| 4 COLLIER ON BANKRUPTCY ¶ 523.05<br>(16th ed. 2012).....                                    | 18         |
| 8B C.J.S. <i>Bankruptcy</i> § 1093 (2012) .....                                             | 12         |
| 124 CONG. REC. H11095-96<br>(daily ed. Sept. 28, 1978) .....                                | 25         |
| 124 CONG. REC. S17412<br>(daily ed. Oct. 6, 1978) .....                                     | 25         |
| 1978 H. REP. NO. 95-595, 2d Sess (1978),<br><i>reprinted in</i> 1978 U.S.C.C.A.N. 6320..... | 28         |
| WEBSTER'S NINTH NEW COLLEGIATE<br>DICTIONARY (1988) .....                                   | 19, 20, 21 |

## INTEREST OF THE *AMICUS CURIAE*<sup>1</sup>

The undersigned *amicus curiae* is an Adjunct Professor of Law at New York University School of Law and a frequent Visiting Lecturer in Law at the Yale Law School where he teaches courses on bankruptcy law, domestic and international business reorganizations, commercial transactions, secured transactions, federal courts, and argument and reason. He began teaching at Yale in 1990, began teaching at NYU in 2012, and has also taught at the Harvard Law School. In addition to his teaching, the undersigned is a contributing author to Collier on Bankruptcy, responsible for writing several chapters of the Treatise. He is also a partner at the law firm of Dechert LLP; a prior Chair of the ABA Business Bankruptcy Committee; a former member of the Judicial Conference Advisory Committee on the Federal Bankruptcy Rules; and a Fellow of the American College of Bankruptcy.

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<sup>1</sup> No counsel for any party has authored this brief in whole or in part, and no party or counsel for a party has made a monetary contribution to the preparation or submission of this brief. See Sup. Ct. R. 37.6. All parties have been timely notified of the undersigned's intent to file this brief; both petitioner and respondent have consented to the filing of this brief. Copies of petitioner's and respondent's consents are filed herewith.

The undersigned has briefed and argued numerous bankruptcy matters before the Court, including *Schwab v. Reilly*, 130 S. Ct. 2652 (2010); *Milavetz, Gallop & Milavetz, P.A. v. United States*, 130 S. Ct. 1324 (2010); *Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008); *Travelers Cas. & Sur. Co. v. Pacific Gas & Elec. Co.*, 549 U.S. 443 (2007); *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365 (2007); *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004); and *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000). He has otherwise participated as counsel for one of the parties in numerous other bankruptcy matters before the Court, including *Stern v. Marshall*, 131 S. Ct. 2594 (2011); *Hamilton v. Lanning*, 130 S. Ct. 2464 (2010); *Central Virginia Cmty. College v. Katz*, 546 U.S. 356 (2006); *Rousey v. Jacoway*, 544 U.S. 320 (2005); *Kontrick v. Ryan*, 540 U.S. 443 (2004); *Lamie v. United States Trustee*, 540 U.S. 526 (2004); *FCC v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293 (2003); and *Connecticut Nat'l Bank v. Germain*, 503 U.S. 249 (1992). In addition, he has prepared and filed with the Court several amicus briefs in bankruptcy cases, including *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012); *Hall v. United States*, 132 S. Ct. 1882 (2012); *Ransom v. FIA Card Servs.*, 131 S. Ct. 716 (2011); *United Student Aid Funds, Inc. v. Espinosa*, 130 S. Ct. 1367 (2010); *Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 547

U.S. 651 (2006); *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440 (2004); *Archer v. Warner*, 538 U.S. 314 (2003); and *Things Remembered, Inc. v. Petrarca*, 516 U.S. 124 (1995).

The undersigned is deeply interested in the subject of bankruptcy law and has written, taught, and lectured on the subject of the bankruptcy discharge, including the exceptions to discharge contained in section 523 of the Bankruptcy Code, 11 U.S.C. § 523. The purpose of this brief is to address matters that bear on the Court's determination of an important bankruptcy issue: what degree of debtor misconduct constitutes a "defalcation" under section 523(a)(4) of the Bankruptcy Code such that the debtor may be denied a discharge in bankruptcy from a debt arising from the misconduct, and specifically, does it include actions that resulted in no loss of trust property? In particular, this brief explains why the debt at issue here should not have been excepted from Petitioner's discharge in light of the text of the governing statutory provision, relevant principles of statutory construction, and the historical use and interpretation in the bankruptcy setting of the term "defalcation." The undersigned argues that the decision of the court below should be reversed and that the correct standard is the "extreme recklessness" standard applied by the Court of Appeals for the Second Circuit in *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 68 (2d Cir. 2007) and the

Court of Appeals for the First Circuit in *Rutanen v. Baylis* (*In re Baylis*), 313 F.3d 9, 19-20 (1st Cir. 2002).<sup>2</sup>

## STATEMENT

In 1978, Curt Bullock, Petitioner's father, created a family trust for the benefit of Petitioner and his siblings. Pet. App. 2a, 17a. The trust's sole asset was Curt's life insurance policy, which had a \$1 million death benefit and accumulated cash value. Pet. App. 17a. Petitioner was named as trustee of the trust, though he was unaware of its existence at that time. Pet. App. 45a.

In 1981, Curt informed his son, Petitioner, of his role as trustee of the trust and requested a loan in the amount of \$117,545.96 to be taken against the cash value of the life insurance policy. Pet. App. 17a. The loan was used to repay debts owed by Petitioner's mother, Imogene Bullock. Pet. App. 2a, 17a. In 1984, Petitioner and his mother obtained an additional loan from the trust in the amount of \$80,257.04 for the ultimate purpose of purchasing business property. Pet. App. 17a. In 1990, Petitioner and his mother obtained a final loan of \$66,223.96 for the pur-

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<sup>2</sup> The undersigned was counsel of record for the debtor/respondent in *Denton v. Hyman*, no. 07-952 (2009) (cert. denied).



chase of additional business property. Pet. App. 2a, 17a. All of the loans were ultimately repaid in full with six percent interest. Pet. App. 17a, 45a, 50a.

The terms of the trust permitted the trustee to borrow against the policy to provide funds to pay the premiums or to satisfy any request of a beneficiary for withdrawal of funds. Pet. App. 17a. Petitioner acknowledged that the money borrowed from the trust at issue here was not used in either of those two ways. Pet. App. 54a.

In 2001, Petitioner's two brothers filed an action in Illinois state court, claiming Petitioner had breached his fiduciary duty as trustee. Pet. App. 17a. The brothers sought to have any profits earned by Petitioner and his mother as a result of the loans remitted to the trust. Pet. App. 17a, 47a. The Illinois court ultimately granted summary judgment in favor of the brothers because the loans were deemed to be self-dealing transactions and therefore breaches of fiduciary duty under Illinois law, despite the fact that the court found that Petitioner did "not appear to have had a malicious motive in borrowing funds from the trust." Pet. App. 45a, 57a. The court awarded the trust \$250,000 in damages, which it estimated to be the benefit Petitioner obtained from the breaches of duty, as well as attorneys' fees to Petitioner's brothers. Pet. App. 17a, 46a.



On October 21, 2009, Petitioner filed for bankruptcy under Chapter 7 of the Bankruptcy Code. Pet. App. 30a. Respondent, as successor trustee of the trust, filed an adversary proceeding seeking, pursuant to 11 U.S.C. § 523(a)(4), to except the Illinois judgment from Petitioner's bankruptcy discharge. Pet. App. 30a. The bankruptcy court ultimately excepted the debt from Petitioner's discharge and the district court and Eleventh Circuit affirmed. Pet. App. 1a-44a.

## SUMMARY OF THE ARGUMENT

The bankruptcy discharge is a foundational aspect of bankruptcy law that vindicates the fundamental bankruptcy policy of the “fresh start”—the idea that an insolvent debtor may be released from preexisting civil liabilities in order to start over in life free from the burden of oppressive indebtedness. Because of the pivotal role of the “fresh start” in advancing Congress's objectives in adopting the various bankruptcy statutes enacted over the past two centuries, Congress has promoted, expanded, and protected the discharge time and again through a variety of legislative means. Recognizing the central role that the discharge plays in the administration of our bankruptcy system, together with the fundamental policy that it serves, this Court has generally interpreted the scope of the discharge generously and has correspondingly interpreted its *exceptions* narrowly to promote Congress's ambition of affording broad fresh start relief to

insolvent individuals. This is important to the nation as a whole because it helps avoid the perpetuation of a class of individuals perennially saddled with oppressive indebtedness. As a general rule, only debts that either (1) arise from *serious* forms of wrongdoing or (2) are treated specially for distinct policy reasons not relevant here are excepted from the discharge.

In order to further the ends of Congress's fresh start policy, this Court has deployed a special canon of construction in cases such as this involving the interpretation of the bankruptcy discharge provisions. That canon directs courts to interpret narrowly the statutory exceptions to discharge relief. That approach is closely analogous to a second canon the Court has adopted with respect to another fundamental policy of bankruptcy law—the goal of “equality of distribution” among a debtor's creditors. In order to advance the policy of equality of distribution, this Court construes narrowly provisions of the Code that give preference (or priority) to one creditor over others. Just as the Court construes narrowly the priority provisions of the Code to advance the policy of equality of distribution, the Court construes narrowly the exceptions to the bankruptcy discharge to advance the policy of the fresh start. Application of that canon here supports the conclusion that Petitioner's debt should not have been excepted from discharge.

Petitioner's cause is likewise advanced by the text of section 523(a)(4) and the historical interpretation of the term "defalcation." In context, the language and history of section 523(a)(4) demonstrate that Congress intended to limit "defalcation" to debts arising from a debtor's serious malfeasance resulting in a diminution of trust property, not simply inadvertent neglect or dereliction of duty. The text of the statute, which places "defalcation" between the terms "fraud," "embezzlement," and "larceny," reflects Congress's intent to limit the application of section 523(a)(4) to debts that arise from a debtor's serious wrongdoing. That interpretation is bolstered by reference to the serious nature of the other "fault" exceptions to the discharge. See, e.g., 11 U.S.C. § 523(a)(9) (debt arising from personal injury caused by the debtor's operation of a motor vehicle or other vessel while intoxicated excepted from discharge). It is further supported by early decisions recognizing that the term "defalcation" as used in an early statutory predecessor to section 523(a)(4) was directed at conduct that "involve[d] moral turpitude or intentional wrong." *Keime v. Graff*, 14 F. Cas. 218, 219-20 (C.C.W.D. Pa. 1878).

In light of the relevant statutory text and the historical treatment of the "defalcation" exception, the interpretation of section 523(a)(4) that the First and Second Circuits have adopted is correct. See *Denton v. Hyman (In re Hyman)*,

502 F.3d 61, 68 (2d Cir. 2007); *Rutanen v. Baylis* (*In re Baylis*), 313 F.3d 9, 19-20 (1st Cir. 2002). These decisions properly hold that the defalcation exception applies only when the debtor's behavior rises to the level of extreme recklessness—something much more akin to fraud, embezzlement, or larceny than negligence or dereliction of office. That approach also properly aligns with the overarching “fresh start” policy of the Bankruptcy Code and Congress's general ambition of promoting it broadly.

It is clear from the facts of this case that Petitioner's conduct does not rise to the level necessary under the defalcation exception to strip him of his discharge and leave him indebted beyond his means, perhaps for life. The state court in this case recognized that although Petitioner had technically engaged in a “self-dealing” transaction under Illinois law, he did not have a malicious motive in doing so. At bottom, he simply made a mistake. He apparently thought that it would be permissible to borrow from a trust of which he was also a beneficiary so long as he repaid the money at the same rate of return that the trust was already receiving from the relevant insurance company (which he did). It turns out that he was incorrect, but that mistake is insufficient to deprive him of the important benefit of his discharge because it simply does not rise to the level necessary to invoke the sanction of non-dischargeability which, for many,

would equate to perpetual insolvency. The decision below should be reversed.

## ARGUMENT

### A. The Court Should Construe the “Defalcation” Exception Narrowly.

Section 523(a)(4) generally excepts from the scope of a debtor’s discharge any debt “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny.” 11 U.S.C. § 523(a)(4). The question presented involves the proper interpretation of the term “defalcation.” Although the terms “fraud,” “embezzlement,” and “larceny” are fairly well-worn, the term “defalcation” is arcane, arising so rarely in common conversation and usage that it is difficult to conclude that it has a “plain” or “fixed” independent meaning, at least in any lay sense. It apparently derives from the archaic term “defalk,” with connotations (according to some authorities) of liability for fraudulent activity resulting in the depletion of funds entrusted to the care of a fiduciary. See *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 17-18 (1st Cir. 2002) (canvassing various dictionary definitions and the origins of the term). Of course, there was no fraud in this case, nor any ultimate deficiency in the funds entrusted: all of the loans were repaid with interest. Here there was merely Petitioner’s unfortunate lapse of appropriate judgment. His conduct



would thus appear to fall outside the traditional scope of the term.

Consistent with the fundamental “fresh start” policy underlying the discharge provisions of the Bankruptcy Code and this Court’s practice of construing the discharge exceptions narrowly, the Court should construe the term “defalcation” narrowly to encompass only financial misdealing by a fiduciary rising to the level of extreme recklessness that results in the depletion of entrusted funds. Doing so has several virtues. First, it avoids infringing upon the discharge through an overbroad construction of an unusual and ambiguous term. Second, it aligns the concept of “defalcation” with its companions in section 523(a)(4)—“fraud,” “embezzlement,” and “larceny”—all of which also connote some form of financial loss. Third, it avoids rendering any of these other terms superfluous because it is distinct: the concept of extremely reckless behavior by a fiduciary that results in financial loss covers conduct that the more technical concepts of “fraud,” “embezzlement,” and “larceny” omit (because, as discussed below, each of these requires evidence of specific intent or its equivalent, whereas extreme recklessness would suffice for defalcation). Fourth, it aligns with historical interpretations of the term. Because the court below construed “defalcation” to encompass more than this narrow interpretation allows, its decision should be reversed.



**1. The Court Should Construe the Exceptions to the Discharge Narrowly to Effectuate the Bankruptcy Code's Fresh Start Policy.**

The discharge is a critical aspect of bankruptcy law, perhaps even *the* most critical of its features. It has long provided much needed relief from oppressive indebtedness to millions of American debtors. Congress has repeatedly acknowledged the benefits of the debtor's discharge, allowing even certain debts owed to the federal government, as well as other governmental entities, to be dischargeable. See 11 U.S.C. § 523; *FCC v. NextWave Personal Commc'ns Inc.*, 537 U.S. 293, 303 (2003).

So important is the discharge that the Bankruptcy Code prevents individuals from waiving it *ex ante* at the time they incur debt, see *id.* § 524(a), and likewise places substantial *ex post* restrictions on the ability of debtors to waive the discharge with respect to particular debts through "reaffirmation" after filing for bankruptcy relief, see *id.* § 524(c). See 8B C.J.S. *Bankruptcy* § 1093 (2012) ("A 'reaffirmation agreement,' . . . is an agreement between a holder of a claim and the debtor, the consideration for which, in whole or in part, is based on a debt that is dischargeable in a case under the Bankruptcy Code. Reaffirmation represents the only vehicle through which an otherwise dischargea-

ble debt can survive the successful completion of Chapter 7 proceedings, and an enforceable reaffirmation agreement makes a debtor remain personally obligated after discharge for a debt which is otherwise dischargeable.”). In fact, even when a debtor wishes to waive his right to a discharge through reaffirmation, the bankruptcy court must essentially ratify the reaffirmation by ensuring that it does not impose an undue hardship on either the debtor or the debtor’s dependents. *See id.* § 524(c)(3)(B); *Renwick v. Bennett (In re Bennett)*, 298 F.3d 1059, 1066-67 (9th Cir. 2002).

These protections did not arise by accident. They were enacted to curtail attempts to limit the discharge because the discharge serves as the primary vehicle through which the Bankruptcy Code’s “fresh start” policy is achieved. As this Court has long recognized, one of the primary purposes of bankruptcy law is to excuse an insolvent debtor “from the weight of oppressive indebtedness, and permit him to start afresh . . . .” *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934) (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554-55 (1915)). Indeed, “[t]his purpose . . . has been again and again emphasized by the courts as being of public as well as private interest” by giving insolvent debtors “a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.” *Id.*

In light of the importance of the fresh start policy under the Bankruptcy Code, this Court has also long recognized that any “exceptions to the operation of a discharge thereunder should be confined to those plainly expressed.” *Gleason v. Thaw*, 236 U.S. 558, 562 (1915). Accordingly, this Court has narrowly construed exceptions to the discharge in an effort to effectuate the Bankruptcy Code’s “fresh start” goal. See *Kawaauhau v. Geiger*, 523 U.S. 57, 62 (1998). Consistent with that narrowing canon, Petitioner’s obligations related to the Illinois court judgment should not be excepted from the scope of his discharge. That result is all the more appropriate here, given that Congress’s use of the arcane term “defalcation” in section 523(a)(4) is hardly a “plain” expression of substantive meaning.

**2. The Court’s Approach of Interpreting Narrowly the Exceptions to Discharge Parallels Its Approach of Interpreting Narrowly the Exceptions to the Code’s Priority Provisions.**

The history of the Court’s approach of interpreting the discharge exceptions narrowly parallels its companion approach of interpreting narrowly the Code’s priority provisions. In addition to the fresh start policy, bankruptcy law also embodies the fundamental policy of equality of

distribution among the creditors of insolvent debtors. *See, e.g., Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) (discussing “the prime bankruptcy policy of equality of distribution” to creditors); *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945) (“historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt’s assets”); *Buchanan v. Smith*, 83 U.S. 277, 301 (1872) (noting the main bankruptcy policy of “[e]qual distribution of property of the bankrupt, *pro rata*”). Of course, the Bankruptcy Code actually honors this policy in the breach: although the Code *generally* requires ratable distribution among creditors, it specifically elevates certain debts above others by affording them priority treatment. *See, e.g.,* 11 U.S.C. § 507. Nonetheless, the policy of equality of distribution endures as a foundational baseline.

Because the Code’s priority provisions have a corrosive effect on the general policy of equality of distribution, the Court has adopted a mediating canon that the priority provisions should be construed narrowly. *See Howard Delivery Serv., Inc. v. Zurich American Ins. Co.*, 547 U.S. 651, 667 (2006). For example, relying specifically on the Code’s aim “to secure equal distribution among creditors,” the Court declined in *Howard Delivery* to afford priority status to premiums paid for workers’ compensation insurance. *Id.* at 655. The Court explained that the

equal distribution objective directs the “corollary principle that provisions allowing preferences must be tightly construed.” *Id.* at 667.

The Court’s decision in *Howard Delivery* did not break new ground—the Court has often employed the same narrowing canon to other provisions allowing preferences in bankruptcy. *See, e.g., Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930) (“The broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the bankrupt’s estate . . . [and] [a]ny agreement which tends to defeat that beneficent design must be regarded with disfavor.”); *see also Nathanson v. NLRB*, 344 U.S. 25, 29 (1952) (“The theme of the Bankruptcy Act is ‘equality of distribution’ . . . and if one claimant is to be preferred over others, the purpose should be clear from the statute.”) (quoting *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) (explaining that in light of the bankruptcy theme of equality of distribution “an unsecured creditor carries a burden of showing by clear and convincing evidence that its application to his case so as to deny him priority would work an injustice.”)). Thus, the canon has become a well-recognized feature of the bankruptcy jurisprudential landscape. *See* 4 COLLIER ON BANKRUPTCY ¶ 507.01 (16th ed. 2012) (“Because priorities grant special rights to the holders of priority claims, priorities under the Code are to be narrowly construed.”).



As this Court has also long recognized, “[t]he discharge of the debtor has come to be an object of no less concern than the distribution of his property.” *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 588 (1935). Indeed, as the Court similarly explained in an early case under the Bankruptcy Act of 1898,

The federal system of bankruptcy is designed not only to distribute the property of the debtor, not by law exempted, fairly and equally among his creditors, but as a main purpose of the act, intends to aid the unfortunate debtor by giving him a fresh start in life, free from debts, except of a certain character, after the property which he owned at the time of bankruptcy has been administered for the benefit of creditors. Our decisions lay great stress upon this feature of the law . . . .

*Stellwagen v. Clum*, 245 U.S. 605, 617 (1918).

Because (1) the Code’s general fresh start policy is no less important than its general policy of equality of distribution, and (2) the Code’s fresh start policy is eroded no less by the exceptions to discharge than the Code’s policy of equality of distribution is eroded by the priority provisions, it follows that the same mediating principle applies in both settings: the exceptions to discharge *and* the priority provisions should

both be construed narrowly. As summarized above, the Court has long taken the path of construing the exceptions to discharge tightly, see, e.g., *Gleason*, 236 U.S. at 562, and the canon requiring narrow construction of the discharge exceptions is no less a familiar feature of the bankruptcy jurisprudential landscape than the canon requiring narrow construction of the priority provisions. See 4 COLLIER ON BANKRUPTCY ¶ 523.05 (16th ed. 2012) (“In determining whether a particular debt falls within one of the exceptions of section 523, the statute should be strictly construed against the objecting creditor and liberally in favor of the debtor.”). Keeping with this tradition, the Court should construe narrowly the “defalcation” exception set forth in section 523(a)(4).

**B. Congress Intended to Limit the Term “Defalcation” in Section 523(a)(4) to Debts Arising from a Debtor’s Serious Malfeasance.**

It is axiomatic that questions regarding the meaning of statutory text must “begin[] with the language of the statute itself.” *United States v. Ron Pair Enters.*, 489 U.S. 235, 241 (1989). In this case, however, that exercise does not take us very far—at least without the assistance of several extrinsic aids, four of which are particularly important here: (1) the canon discussed above requiring the narrow construction of the excep-

tions to discharge relief, (2) the canon *noscitur a sociis*, (3) the whole act canon requiring consideration of section 523(a)(4) in context with the entirety of section 523(a), and (4) consideration of the historical interpretation of the “defalcation” concept as used in a succession of bankruptcy laws.

Dictionary definitions of the term “defalcation” are not particularly helpful. *See, e.g.,* WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY 332 (1988) (“1. *Archaic*: deduction 2: the act or an instance of embezzling 3: a failure to meet a promise or an expectation”) (hereinafter WEBSTER’S); *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 17-18 (1st Cir. 2002) (canvassing various dictionary definitions covering a broad variety of definitional possibilities and describing the origins of the term). Where, as here, the various dictionary definitions lead to no easy answer and the word at issue is nested in a list, courts routinely rely on the doctrine *noscitur a sociis* as a guide to interpretation—“a word is known by the company it keeps.” *Gustafson v. Alloyd Co.*, 513 U.S. 561, 575 (1995). In this way, courts “avoid ascribing to one word a meaning so broad that it is inconsistent with its accompanying words, thus giving ‘unintended breadth to the Acts of Congress.’” *Id.* (quoting *Jarecki v. G.D. Searle & Co.*, 367 U.S. 303, 307 (1961)). That is particularly appropriate here, given the impact that the

exceptions to discharge have on the general fresh start policy.

In this case, then, the term “defalcation” must be “read in context to refer to writings that, from a functional standpoint, are similar to” the terms “fraud,” “embezzlement,” and “larceny.” *Id.* at 576; *see also Beecham v. United States*, 511 U.S. 368, 371 (1994) (“That several items in a list share an attribute counsels in favor of interpreting the other items as possessing that attribute as well.”); *Jarecki*, 367 U.S. at 307 (the term at issue “does not stand alone, but gathers meaning from the words around it.”). Importantly, “[f]raud, embezzlement and larceny are all serious crimes requiring specific intent.” *Baylis*, 313 F.3d at 20. Similarly, to the extent that section 523(a)(4) “covers civil actions for fraud, such as a fraudulent misrepresentation, the maker of the statement must know or believe the statement is untrue or that he has no basis to make the statement.” *Id.* (citing RESTATEMENT (SECOND) OF TORTS § 526 (1976)).

According to WEBSTER’S, the term “fraud” means “deceit, trickery . . . intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right . . . an act of deceiving or misrepresenting.” WEBSTER’S 490. The term “embezzle” means “to appropriate (as property entrusted to one’s care) fraudulently to one’s own use.” WEBSTER’S 406.

The term "larceny" means "the unlawful taking of personal property with intent to deprive the rightful owner of it permanently: theft." WEBSTER'S 674. All of these terms indisputably involve serious and intentional wrongdoing as opposed to mere negligence or dereliction of office. Thus, the inclusion of "defalcation" in section 523(a)(4) together with the terms listed above strongly indicates Congress's intention to limit the application of that term to debts arising from a debtor's serious malfeasance. *Cf. Hickman v. Texas*, 260 F.3d 400, 403-04 (5th Cir. 2001) (using the *noscitur a sociis* doctrine to conclude that Congress intended to limit application of 11 U.S.C. § 523(a)(7) to forfeitures imposed upon a wrongdoing debtor).

This makes sense when one views section 523(a)(4) against the backdrop of section 523(a) as a whole. The exceptions to discharge in section 523(a) exist for one of two reasons. First, discharge may not be used to avoid the repayment of certain debts that are of special importance for distinct policy reasons (*e.g.*, certain taxes or customs duties (§ 523(a)(1)); debts incurred to pay certain taxes (§ 523(a)(14)); alimony and child support obligations (§ 523(a)(5)); fines, penalties or forfeitures to the government (§ 523(a)(7)); educational loans made or insured by the government or a nonprofit institution, except in cases of undue hardship (§ 523(a)(8)); restitution orders (§ 523(a)(13)); court fees (§



523(a)(17)); and support owed under state law and enforceable under the social Security Act (§ 523(a)(18)). *See Baylis*, 313 F.3d at 19. This first category of discharge exceptions are driven by the type of debt rather than the level of fault of the debtor. *Id.* Critically, the defalcation exception is not contained within any of these sections.

The second category includes exceptions based on the type of *fault* that caused the debt rather than the type of debt. These include debts based on money, goods or services obtained by fraud or falsehood (§ 523(a)(2)); willful and malicious injury (§ 523(a)(6)); death or injury caused by driving under the influence of alcohol or drugs (§ 523(a)(9)); and the exception at issue in this case: “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny” (§ 523(a)(4)). *See Baylis*, 313 F.3d at 19. The exception to discharge set forth in section 523(a)(12), “for malicious or reckless failure” to maintain capital of an insured depository institution to the extent required by federal regulatory agencies, combines both categories—a level of fault together with a type of debt important for policy reasons. *See Baylis*, 313 F.3d at 19.

The “type of fault” exceptions concern “extremely serious actions done knowingly or with great risk of harm to others.” *Id.* Because the defalcation exception falls within this second

camp, the Court should conclude that, based on the structure of section 523(a) as a whole, “for an act to fall under the ‘defalcation’ exception to discharge, it must be a serious one indeed, and some fault must be involved.” *Id.*

This approach is consistent with the historical interpretation of the word “defalcation” in the statutory predecessor to section 523(a)(4). This history is relevant because, as the Court has explained, it “will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure.” *Hamilton v. Lanning*, 130 S. Ct. 2464, 2473-74 (2010); *see also Travelers Cas. & Surety Co. of America v. Pacific Gas & Elec. Co.*, 549 U.S. 443, 454 (2007); *Lamie v. U.S. Trustee*, 540 U.S. 526, 539 (2004). In this instance, there is no indication that when Congress included section 523(a)(4) as part of the Bankruptcy Code in 1978, it intended the term “defalcation” to be broader than its historical interpretation.

In recognizable form, the statutory provision at issue here has been part of the nation’s bankruptcy law since at least the Bankruptcy Act of 1867, and traces its roots even farther to the Bankruptcy Act of 1841. *Baylis*, 313 F.3d at 17 (citing An act to establish a uniform system of bankruptcy through the United States, ch. CLXXVI, § 33, 14 Stat. 517, 533 (1867) (repealed 1878) and An act to establish a uniform system

of bankruptcy throughout the United States, ch. IX, § 1, 5 Stat. 440, 441 (1841) (repealed 1843) (excepting only debts arising from "defalcation as a public officer")).

An older case on point is *Keime v. Graff*, where the court considered the meaning of "the thirty-third section of the bankrupt law [Act of 1867], which enacts that 'no debt created by the fraud or embezzlement of the bankrupt, or by his defalcation as a public officer, or while acting in any fiduciary character, shall be discharged by proceedings in bankruptcy.'" 14 F. Cas. 218, 218 (C.C.W.D. Pa. 1878). The court held that,

applying the rule *noscitur a sociis* to the interpretation of this language, its meaning is clearly the same as that employed in the act of 1841. . . . [T]he term, 'defalcation,' which must be read in connection with the phrase in question, to make it intelligible, imports a greater degree of culpability than that which attaches to a refusal or failure to pay a debt, even though it is attended by a breach of confidence. It involves 'moral turpitude or intentional wrong,' hence it is associated with liabilities of like moral character and imports a classification of kindred subjects.

*Id.* at 220.

Analogously, in *Neal v. Clark*, this Court considered the same provision, this time with respect to the term "fraud," stating that "[i]n the construction of statutes, . . . the rule *noscitur a sociis* is very frequently applied; the meaning of a word, and, consequently, the intention of the legislature, being ascertained by reference to the context, and by considering whether the word in question and the surrounding words are, in fact, *ejusdem generis*, and referable to the same subject-matter." 95 U.S. 704, 709 (1877). The Court concluded that,

in the section of the law of 1867 which sets forth the classes of debts which are exempted from the operation of a discharge in bankruptcy, debts created by 'fraud' are associated directly with debts created by 'embezzlement.' Such association justifies, if it does not imperatively require, the conclusion that the 'fraud' referred to in that section means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong, as does embezzlement; and not implied fraud, or fraud in law, which may exist without the imputation of bad faith or immorality.

*Id.*; see also 124 CONG. REC. H11095-96 (daily ed. Sept. 28, 1978); S17412 (daily ed. Oct. 6, 1978) (statements of Rep Edwards and Sen. DeConcini)

("Subparagraph (A) is intended to codify current case law *e.g.*, *Neal v. Clark*, 95 U.S. 704 (1887), which interprets 'fraud' to mean actual or positive fraud rather than fraud implied in law."); *Tsurukawa v. Nikon Precision, Inc. (In re Tsurukawa)*, 258 B.R. 192, 197 (B.A.P. 9th Cir. 2001).

Thus, based on (1) application of the bankruptcy canon that the exceptions to the discharge should be construed narrowly; (2) application of the general canon *noscitur a sociis* to align the meaning of the term "defalcation" with its companion terms "fraud," "embezzlement," and "larceny"; (3) consideration of section 523(a)(4) in context with section 523(a) as a whole; and (4) the historically narrow construction of the term "defalcation" and other terms in section 523(a)(4), this Court should conclude that Congress intended to limit the application of the section to debts arising from a debtor's serious malfeasance, and specifically to defalcations by a debtor engaged in the most serious wrongdoing resulting in actual loss.



**C. The First and Second Circuits' Conclusion that "Defalcation" Exists Only When the Debtor's Behavior Rises to the Level of Extreme Recklessness Is the Most Faithful to the Language, Structure, and History of Section 523(a)(4).**

As discussed above, the "defalcation" provision has been part of the bankruptcy statutes since 1841, and since that time, many courts have weighed in concerning the degree of misconduct that is necessary to satisfy its requirements. Petitioner's brief discusses the relevant circuit split, Pet. Br. 12-15, which is not repeated here. It is worth reiterating, however, that the Court's post-1867 decisions consistently rejected an expansionary reading of section 523(a)(4)'s statutory predecessor. *See, e.g., Davis v. Aetna Acceptance Co.*, 293 U.S. 328 (1934) (Cardozo, J.) (interpreting Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1978)); *Crawford v. Burke*, 195 U.S. 176, 189-90 (1904) (same).

The current text of section 523(a)(4) was enacted as part of the 1978 Bankruptcy Reform Act. That Act deleted the term "misappropriation" appearing in section 17 of the Act of 1898, and revised the statutory language so that embezzlement and larceny were not limited to debtors acting in a fiduciary capacity, and fraud was limited to fiduciary situations because a separate

provision, section 523(a)(2) covers other kinds of fraud. See *Angelle v. Reed (In re Angelle)*, 610 F.2d 1335, 1341 n.12 (5th Cir. 1980) (discussing section 523(a)(4) of the Bankruptcy Reform Act, 11 U.S.C. § 523(a)(4)).<sup>3</sup> The limited legislative history that is available indicates that section 523(a)(4) was intended to reach debts incurred through a debtor's malfeasance: "Paragraph (4) excepts debts for embezzlement or larceny. The deletion of willful and malicious conversion from Sec. 17a(2) of the Bankruptcy Act is not intended to effect a substantive change. The intent is to include in the category of non-dischargeable debts a conversion under which the debtor *willfully and maliciously intends* to borrow property for a short period of time with no intent to inflict injury but on which injury is in fact inflicted." 1978 H. REP. NO. 95-595, 2d Sess., at 364 (1978), reprinted in 1978 U.S.C.C.A.N. 6320 (emphasis added). In this instance, of course, the state court found that Petitioner acted without malicious intent. Further, there was no actual injury because the loans were repaid. Consistent with

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<sup>3</sup> Section 17(4) excepted from the debtor's discharge debts that "were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity." Act of July 1, 1898, ch. 541, § 17(4), 30 Stat. 550-51 (repealed 1978). If anything, Congress's removal of the term "misappropriation" when it codified this provision in revised form as part of the new section 523(a)(4) demonstrates that Congress intended to narrow further the scope of the exception.

the legislative history, Petitioner's conduct in this case falls outside the purview of the kind of malfeasance Congress indicated it was targeting when it revised the fault provisions of section 523(a).

In *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510 (2d Cir. 1937) (Learned Hand, J.), the Second Circuit took a different approach, issuing a “carefully equivocal opinion,” *Rutanen v. Baylis (In re Baylis)*, 313 F.3d 9, 18 (1st Cir. 2012); see also *Denton v. Hyman (In re Hyman)*, 502 F.3d 61, 67 (2d Cir. 2007) (“In *Herbst*, Judge Learned Hand wrestled with this problem without resolving it.”). The Second Circuit's analysis in *Herbst* departed significantly from this Court's approach to the interpretation of section 523(a)'s statutory predecessor in *Neal* and other decisions like *Keime v. Graff*, holding that defalcation could exist even in the absence of deliberate wrongdoing. *Baylis*, 313 F.3d at 18; see also *Hyman*, 502 F.3d at 67. Specifically, the Second Circuit stated in *Herbst*: “[c]olloquially perhaps the word, ‘defalcation,’ ordinarily implies some moral dereliction, but in this context [the reference to defalcation in section 17 of the Act of 1898], it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts.” *Herbst*, 93 F.2d at 511.

Thus, rather than employ the canon *noscitur a sociis* (as this Court had in *Neale*) to find common attributes and similar ground between the word “defalcation” and its companions and then construe them all in like fashion, the Second Circuit in *Herbst* focused on finding *difference*: “[w]hatever was the original meaning of ‘defalcation,’ it must here have covered other defaults than deliberate malversations, else it added nothing to the words, ‘fraud or embezzlement.’” *Herbst*, 93 F.2d at 511; *see also Hyman*, 502 F.3d at 67. Indeed, the Second Circuit essentially rejected this Court’s *noscitur a sociis* method, stating: “[i]t does not seem to us . . . that [the] linkage of ‘fraud’ and ‘embezzlement’ to ‘defalcation’ need change its meaning . . . . We must give the words different meanings so far as we can.” *Herbst*, 93 F.2d at 511-12. In the end, the court concluded that “[a]ll we decide is that when a fiduciary takes money upon a conditional authority which may be revoked and knows at the time that it may, he is guilty of a ‘defalcation’ though it may not be a ‘fraud,’ or an ‘embezzlement,’ or perhaps not even a ‘misappropriation.’” *Id.* Respectfully, the analysis in *Herbst* is wrong, and the Second Circuit properly repudiated it in its subsequent decision in *Hyman*.

Since *Herbst*, courts (including prominently the Second Circuit itself) have expressed different views on the proper interpretation of section 523(a)(4), giving rise to the current conflict

among the courts of appeals, with some courts holding that an innocent mistake can constitute defalcation, others requiring negligence but no more, and still others, including the First Circuit in *Baylis* and the Second Circuit in *Hyman*, departing from *Herbst* after looking carefully at the language and history of the statute, and requiring at least extreme recklessness. See *Hyman*, 502 F.3d at 66 (“This Circuit, although previously having suggested that “some portion of misconduct” may be required to establish a ‘defalcation’ under § 523(a)(4), has yet to squarely address this issue.”) (citing *Herbst*, 93 F.2d at 512).

In *Hyman*, after discussing the circuit split in some detail, the Second Circuit decided to follow the First Circuit’s decision in *Baylis*, which set the “highest bar, requiring a showing of extreme recklessness, ‘akin to the level of recklessness required for scienter [in securities law].” *Hyman*, 502 F.3d at 68 (quoting *Baylis*, 313 F.3d at 20)). In *Baylis*, the First Circuit described this form of recklessness as “an extreme departure from the standards of ordinary care.’ The mental state required for defalcation is akin to the level of recklessness required for scienter. It is more than the mere conscious taking of risk associated with the usual torts standard of recklessness. Instead, defalcation requires something close to a showing of extreme recklessness.” 313 F.3d at 20 (citations omitted).



Both circuits thus interpret “defalcation” as “requiring a degree of fault, ‘closer to fraud, without the necessity of meeting a strict specific intent requirement.’” *Hyman*, 502 F.3d at 68. Of all the standards for measuring defalcation embraced by the various courts, the extreme recklessness standard hews most closely to the language of section 523(a)(4), the provisions contained in section 523(a) as a whole, and the historical treatment (other than in *Herbst*) of the term “defalcation” and of other terms in section 523(a)(4) discussed above.

As a policy matter, this approach makes sense because “the harsh sanction of non-dischargeability is reserved for those who exhibit ‘some portion of misconduct,’ . . . [but] does not reach fiduciaries who may have failed to account for funds or property for which they were responsible only as a consequence of negligence, inadvertence or similar conduct not shown to be sufficiently culpable.” *Hyman*, 502 F.3d at 68-69 (citation omitted). In the circumstances of this case, Petitioner’s acts, one of which was done at the express behest of the Settlor of the trust, his father, to benefit his mother, and the other two of which were loans to himself and his mother (all of which were repaid in full with interest), do not come close to reaching the level of extreme recklessness that would trigger application of section 523(a)(4). *See, e.g.*, Pet. App. 45a (Order of the Circuit Court for the Fifth Judicial Circuit

of Illinois) (Dec. 23, 2002) (“*The Defendant in this case does not appear to have had a malicious motive in borrowing funds from the trust. Up until the time the first loan was made by the Trust, the evidence shows that the Defendant was unaware of the existence of the Trust or of his position as trustee. The first loan was taken at the request of the Defendant’s father, who was also the settlor of the Trust, for the benefit of the Defendant’s mother. . . . The Defendant has shown his willingness to make the Trust whole by a pattern of payments he has made to repay the loans from the Trust. The evidence shows the loans have been, in fact, repaid in full.*”) (emphasis added); see also Pet. App. 18a-19a (United States District Court opinion) (March 22, 2011) (“Bullock’s two sisters both asked the Bankruptcy Court to release Bullock from the debt because the litigation has been going on for fourteen years and needed to stop.”). The decision of the court below should be reversed.

## CONCLUSION

For the foregoing reasons, as well as those offered by Petitioner, the decision of the court below should be reversed.

Respectfully submitted,

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